Foundation level

Accounting Concepts and Principles

2012

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Each chapter contains a number of helpful features to guide you through each topic.

**Learning objectives**  Show the referenced CPA Australia learning objectives.

**Topic list**  Tells you what you will be studying in this chapter.

**Introduction**  Presents a general idea of what is covered in this chapter.

**Chapter summary diagram**  Summarises the content of the chapter, helping to set the scene so that you can gain the bigger picture.

**Before you begin**  This is a small bank of questions to test any pre-existing knowledge that you may have of the chapter content. If you get them all correct then you may be able to reduce the time you need to spend on the particular chapter. There is a commentary section at the end of the Study Manual called Before you begin: answers and commentary.

**Section overview**  This summarises the key content of the particular section that you are about to start.

**Learning objective reference**  This box indicates the learning objective covered by the section or paragraph to which it relates.

**Definition**  Definitions of important concepts. You really need to know and understand these before the exam.

**Exam comments**  These highlight points that are likely to be particularly important or relevant to the exam. (Please note that this feature does not apply in every Foundation Level study manual.)

**Worked example**  This is an illustration of a particular technique or concept with a solution or explanation provided.

**Question**  This is a question that enables you to practise a technique or test your understanding. You will find the solution at the end of the chapter.

**Key chapter points**  Review the key areas covered in the chapter.
Quick revision questions

A quick test of your knowledge of the main topics in this chapter.

The quick revision questions are not a representation of the difficulty of the questions which will be in the examination. The quick revision multiple choice questions (MCQs) provide you with an opportunity to revise and assess your knowledge of the key concepts covered in the materials so far. Use these questions as a means to reflect on key concepts and not as the sole revision for the examination.

Revision questions

The revision questions are not a representation of the difficulty of the questions which will be in the examination. The revision MCQs provide you with an opportunity to revise and assess your knowledge of the key concepts covered in the materials so far. Use these questions as a means to reflect on key concepts and not as the sole revision for the examination.

Case study

This is a practical example or illustration, usually involving a real world scenario.

Formula to learn

These are formulae or equations that you need to learn as you may need to apply them in the exam.

Bold text

Throughout the Study Manual you will see that some of the text is in **bold type**. This is to add emphasis and to help you to grasp the key elements within a sentence and paragraph.
Chapter summary

This summary provides a snapshot of each of the chapters, to help you to put the syllabus as a whole and the Study Manual itself into perspective.

**Chapter 1 – Introduction to accounting**
The basic reasons for the development of accounting, and the needs of the key stakeholders, are discussed here. You will see that accounting is an essential attribute of any well-organised business.

**Chapter 2 – The regulatory framework**
The different sources of regulation of accounting are considered here including national legislation, Stock Exchange requirements and both local and International Financial Reporting Standards (IFRS). In particular, you will become aware of the importance of the International Accounting Standards Board (IASB) and the International Financial Reporting Standards (IFRS) that it issues.

**Chapter 3 – The conceptual framework of accounting**
The idea of a conceptual framework for financial reporting is considered in general but there is a specific focus on the IASB's *Conceptual Framework for Financial Reporting* (Conceptual Framework) which is the basis upon which all IFRS are prepared.

**Chapter 4 – Accounting standards and concepts**
You will consider here the role and purpose of accounting standards, the process of preparing new accounting standards and the concepts that underlie the preparation of both accounting standards and financial statements.

**Chapter 5 – Elements of financial statements and their recognition criteria**
This chapter considers the elements of financial statements as set out in the IASB’s *Conceptual Framework* – these are assets, liabilities, equity, revenue and expenses. You will learn the recognition criteria for each of these elements.

**Chapter 6 – Alternative methods of valuation**
The most common measure of asset / liability valuation is historical cost. However, here you will learn how to identify, explain and calculate other methods of valuation.

**Chapter 7 – Alternative theories of accounting**
Carrying on from the previous chapter which considered alternative methods of valuation, in this chapter you will consider alternative methods of measuring capital and how this ties in with asset / liability valuation.

**Chapter 8 – Reporting and disclosure of performance**
In a company the shareholders are the owners, but the company is managed by the directors. The directors are agents of the shareholders, therefore you will consider what is meant by agency theory. You will also look at the information disclosed in financial statements which allow the shareholders to assess the performance of the company and of its directors.
Chapter 9 – Efficiency in capital markets and company reporting

In this chapter you will be looking at various theories that seek to provide a rationale for share price movements – the efficient market hypothesis. You will also consider the various types of information that are available to shareholders in the reported financial statements.
Answering multiple choice questions (MCQs)

The questions in your exam will each contain four possible answers. You have to **choose the option that best answers the question**. The three incorrect options are called distractors. There is a skill in answering MCQs quickly and correctly. By practising MCQs you can develop this skill, giving you a better chance of passing the exam.

You may wish to follow the approach outlined below, or you may prefer to adapt it.

**Step 1**
Attempt each question – starting with the easier questions which will be those at the start of the exam. Read the question thoroughly. You may prefer to work out the answer before looking at the options, or you may prefer to look at the options at the beginning. Adopt the method that works best for you.

**Step 2**
Read the four options and see if one matches your own answer. Be careful with numerical questions, as the distractors are designed to match answers that incorporate common errors. Check that your calculation is correct. Have you followed the requirement exactly? Have you included every stage of the calculation?

**Step 3**
You may find that none of the options matches your answer.
- Re-read the question to ensure that you understand it and are answering the requirement
- Eliminate any obviously wrong answers
- Consider which of the remaining answers is the most likely to be correct and select the option

**Step 4**
If you are still unsure make a note and continue to the next question. Some questions will take you longer to answer than others. Try to reduce the average time per question, to allow yourself to revisit problem questions at the end of the exam.

**Step 5**
Revisit unanswered questions. When you come back to a question after a break you often find you are able to answer it correctly straight away. If you are still unsure have a guess. You are not penalised for incorrect answers, so **never leave a question unanswered!**
Learning objectives

CPA Australia’s learning objectives for this Study Manual are set out below. They are cross-referenced to the chapter in the Study Manual where they are covered.

Accounting Concepts and Principles

General overview

This exam covers a critical awareness of accounting issues in an international context. It requires an understanding of the theoretical concepts within the regulatory and conceptual framework of corporate reporting. This includes recognition criteria, methods of valuation, and reporting and disclosure of the financial performance of companies.

These are the topics that will be covered in the exam.

Topics

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<td>2 The regulatory framework</td>
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<td>5 Elements of financial statements and their recognition criteria</td>
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<td>6 Alternative methods of valuation</td>
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<td>7 Alternative theories of accounting</td>
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<td>8 Reporting and disclosure of performance</td>
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<tr>
<td>9 Efficiency in capital markets and company reporting</td>
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<td><strong>TOTAL</strong></td>
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Chapter 1
Introduction to accounting

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<td>information to users</td>
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Topic list

1. The purpose of accounting information
2. Nature, principles and scope of financial reporting
3. Users’ and stakeholders’ needs
4. The need for financial accounting systems
5. Control over business transactions
7. The information provided by financial accounting systems
This chapter introduces some basic ideas about the need for financial information and the users of financial information. It also covers the definition of financial reporting and the uses of accounting information in the organisation. Finally, the main types of systems in an organisation and the financial systems are discussed.
Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If
this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the
subject matter, but you should still skim through the chapter to ensure that you are familiar with everything
covered.

There are references in brackets indicating where in the chapter you can find the information, and you will
also find a commentary at the back of the Study Manual.

1  Who are the main user groups of financial statements, and why are they interested
in financial information?  (Section 3.2)
2  Identify three differences between financial and management accounts.  (Section 2)
3  Where in the accounting system are credit sales recorded?  (Section 5.3)
4  Give three examples of areas where financial control procedures are
required.  (Sections 5.4 and 5.5)
5  Identify four advantages of a computerised accounting system over a manual
accounting system.  (Section 6.2)
1 The purpose of accounting information

1.1 What is accounting?

Section overview

- Accounting is the process of recording, analysing and summarising transactions of a business and communicating that information to decision makers.
- A business is an entity which exists to make a profit
- There are three main types of business entity: sole traders, partnerships and limited liability companies.
- Non-commercial undertakings such as charities and clubs will also prepare accounts.

If we are going to be studying accounting concepts and principles then it is important to understand initially what the accounting function is and how it plays its part in an organisation. The accounting function is part of the broader business system, and does not operate in isolation. It handles the financial operations of the organisation, but also provides information and advice to other departments.

Definition

Accounting is the process of identifying, measuring, recording and communicating economic information to others so that they may make decisions on the basis of that information.

Accounts are produced to aid management in planning, control and decision-making and to comply with statutory regulations. The accounting system must be adequate to fulfil these functions. An organisation’s accounting systems are affected by the nature of its business transactions and the sort of business it is.

<table>
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<tr>
<th>Factor</th>
<th>Example</th>
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<tr>
<td>Size</td>
<td>A small business like a greengrocer will have a simple accounting system, where the main accounting record will probably be the cash register roll. A large retail business, such as a chain of supermarkets, will have elaborate accounting systems covering a large number of product ranges and sites.</td>
</tr>
<tr>
<td>Type of organisation</td>
<td>A service business might need to record the time employees take on particular jobs. Accounting on a job or client basis might also be a feature of service businesses. A public sector organisation, such as a government department, may be more concerned with the monitoring of expenditure against performance targets than recording revenue. A manufacturing company will account for both unit sales and revenue, but needs to keep track of costs for decision-making purposes and so forth.</td>
</tr>
<tr>
<td>Organisation structure</td>
<td>In a business managed by area, accounts will be prepared on an area basis. In a functional organisation, the accounts staff are in a separate department.</td>
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Be aware that accounting work has to comply with a wide range of regulations to avoid penalties, including law such as the Corporations Act 2001. As a result, it tends to be rather formalised and procedural in order to make sure that nothing is overlooked. Organisations often lay down their accounting rules and procedures in writing, and this may form part of an organisation manual or procedures manual.

1.2 The need for accounts

Renaissance scholar Luca Pacioli wrote the first printed explanation of double-entry bookkeeping in 1494. Double-entry bookkeeping involves entering every transaction as a debit in one account and a corresponding credit in another account, and ensuring that they 'balance'. Pacioli’s description of the method was widely influential.
The first English book on the subject was written in 1543. The practice of double-entry bookkeeping has barely changed since then and is standard across the world, based upon the concept that every transaction has a dual effect that balances to zero.

The original role of the accounting function was to record financial information and this is still its main focus.

Why do businesses need to produce accounts? If a business is being run efficiently, why should it have to go through all the bother of accounting procedures in order to produce financial information?

A business needs to produce information about its activities because there are various groups of people who want or need to know that information. Later in this chapter we will consider the different groups of users and the type of information that is of interest to the members of each group.

1.3 What is financial reporting?

**Definition**

Financial reporting (sometimes called financial accounting) is the process of classifying, recording and presenting financial data in accordance with generally established concepts and principles.

**Financial data** is the name given to the actual transactions carried out by a business e.g. sales of goods, purchases of goods, payment of expenses.

**Financial reporting** is the name given to the function of **reporting financial information to users** of the financial statements. This requires a company to **publish** financial information at the end of an accounting period. For many companies this will be at the end of the financial year, although larger companies that are listed on a stock exchange will report information on a more frequent basis.

**Question 1: Financial reporting**

Financial reporting means the financial statements produced only by a large listed company.

Is this statement correct?

A yes
B no

(The answer is at the end of the chapter)

1.4 What is a business?

**Definitions**

Businesses of whatever size or nature exist to make a profit.

A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

There are a number of different ways of looking at a business. Some ideas are listed below.

- A business is a **commercial or industrial concern** which exists to deal in the manufacture, re-sale or supply of goods and services.
- A business is an **organisation that uses economic resources** to create goods or services which customers will buy.
- A business is an **organisation providing jobs** for people.
- A business invests money in resources e.g. buildings, machinery, employees, in order to make even more money for its owners.
This last definition introduces the important idea of profit. Businesses vary from very small businesses e.g. the local shopkeeper or plumber, to very large ones e.g. IKEA, Nestlé, Unilever. However all of them want to earn profits.

**Definition**

Profit is the excess of revenue (income) over expenditure. When expenditure exceeds revenue, the business is running at a loss.

One of the jobs of an accountant is to measure revenue and expenditure, and so profit.

### 1.5 Types of business entity

There are three main types of business entity:

- Sole traders
- Partnerships
- Limited liability companies

Sole traders are people who work for themselves. Examples may include the local shopkeeper, a plumber and a hairdresser. The term sole trader refers to the ownership of the business – sole traders can have employees.

Partnerships occur when two or more people decide to run a business together. Examples may include an accountancy practice, a medical practice and a legal practice.

Limited liability companies are incorporated to take advantage of ‘limited liability’ for their owners (shareholders). This means that, while sole traders and partners are personally responsible for the amounts owed by their businesses, the shareholders of a limited liability company are only responsible for the amount to be paid for their shares.

Generally, in law sole traders and partnerships are not separate entities from their owners. This is true in many jurisdictions, for example Australia, the UK, India, New Zealand, China, Japan and Germany. In the US, however, partnerships do have separate legal personality but the partners are wholly liable for debts. In all cases, however, a limited liability company is legally a separate entity from its owners and it can issue contracts in the company’s name.

For accounting purposes, all three entities are treated as separate from their owners. This is called the business entity concept. The methods of accounting used in all three types of business entity will be very similar, although will tend to become more complex the larger the entity.

#### 1.5.1 Non-commercial undertakings

It is not only businesses that need to prepare accounts. Charities and clubs, for example, prepare financial statements every year. Accounts also need to be prepared for government organisations (public sector organisations such as hospitals and local councils).

### 2 Nature, principles and scope of financial reporting

#### Section overview

- You should be able to distinguish the following:
  - Financial accounting
  - Management accounting

You may have a wide understanding of what accounting and financial reporting is about. Your job may be in one area or type of accounting, but you must understand the breadth of work which an accountant undertakes. In particular, you need to understand the distinction between financial accounting and management accounting.
2.1 Financial accounting

Financial accounting is mainly a method of reporting the results and financial position of a business. It is not primarily concerned with providing information towards the more efficient running of the business. Although financial accounts are of interest to management, their principal function is to satisfy the information needs of persons not involved in running the business. They provide historical information.

2.2 Management accounting

The information needs of management go far beyond those of other account users. Managers have the responsibility of planning and controlling the resources of the business and for making decisions about the direction of the business both in the longer-term and on a day-to-day basis. Therefore they need much more detailed information. They also need to plan for the future e.g. budgets, which predict future revenue and expenditure.

Definition

Management accounting, sometimes known as cost accounting, is a management information system which analyses data to provide information as a basis for managerial action. The concern of a management accountant is to present accounting information in the form most helpful to management.

2.3 General purpose financial reporting

Accounting Standards (and company law in some countries) prescribe that a company should produce accounts to be presented to the owners (shareholders). Accounts must normally be presented at least annually, and there are usually detailed regulations on what they must contain and the form they must take. For example, in Australia, the form and content of limited company financial statements is regulated by the Corporations Act 2001 and by Australian Accounting Standards, (AASB), which are equivalent to International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

Large listed companies (sometimes known as public companies) are required to publish their annual financial statements. A listed company is a company whose shares or debt instruments are publicly traded on a stock exchange. Published financial statements may be printed or made available on the company’s website. In some countries, for example the UK, all limited companies must ‘publish’ their annual accounts by filing them with the Registrar of Companies. They are then available to members of the public.

These ‘published’ annual accounts are general purpose financial statements or general purpose financial reports. They contain information which may be useful to a wide range of users external to the company. They are distinct from special purpose financial reports which are prepared for a particular group of users and for a particular purpose. Share prospectuses and tax computations are examples of special purpose financial reports.

Some users of published financial statements are able to obtain additional information. For example, owners or lenders may be able to request forecasts and budgets and members of the public have access to information in the financial press or on the internet. However, generally, most external users have to rely on the annual financial statements as their major source of financial information.

A complete set of financial statements for a reporting entity normally includes:

- statement of financial position
- statement of comprehensive income
- statement of changes in equity
- statement of cash flows
- accounting policies and explanatory notes
Definition

A **reporting entity** is an entity whose general purpose financial statements are relied upon by other parties, or by users of the accounts. Most reporting entities are limited liability companies, but a reporting entity can be any type of entity.

Financial statements do not include directors’ reports, statements by the chairman, management commentaries or environmental and social reports, although these may be included in the published annual report of a large listed company (see Chapter 9).

### 2.4 Limitations of financial reporting

General purpose financial statements cannot possibly provide all the information that external users might need about a company or business. Users may also need to consider information from other sources, such as general economic conditions, the political situation and conditions in the industry in which the business operates.

There are other inherent limitations of the financial accounting and reporting process:

- **Financial statements are based on estimates and judgments.** For example, management must estimate the useful lives of assets and the likelihood that amounts receivable will actually be received. Preparing financial statements and reports involves classifying and aggregating information about transactions and other events. It also involves allocating the effects of continuous business transactions over separate accounting periods.

- **Financial statements are based on historical information.** They do not reflect future events or transactions that may affect the business and the way that it operates. Users of the financial statements normally need to predict how well a business will perform in future and to understand the factors which may affect its future performance.

- **Financial statements largely record only the financial effects of transactions and events.** For example, intangible assets such as the technical expertise of the workforce may have a very significant effect on a company’s performance. However, these ‘assets’ are not recognised because they cannot be reliably valued at a monetary amount. Financial statements do not include non-financial information such as discussion of the risks and uncertainties that a business faces, or a description of its effect on the natural environment.

### 3 Users' and stakeholders' needs

**Section overview**

- There are various groups of people who need information about the activities of a business.

#### 3.1 The need for financial statements

The purpose of financial statements is to provide useful information about the **financial position**, **performance** and **changes in financial position** of an entity to a wide range of users.

Users need this information for two reasons:

- to make economic decisions; and
- to assess the stewardship of management.

#### 3.1.1 Making economic decisions

The types of economic decisions for which financial statements are likely to be used include the following:

- Decisions to buy, hold or sell equity investments
- Assessment of management stewardship and accountability
- Assessment of the entity’s ability to pay employees
- Assessment of the security of amounts lent to the entity
3.1.2 Stewardship

Stewardship is relevant where an organisation is managed by people other than its owners. For example, the owners of a large listed company appoint directors to run the company on their behalf, who are then accountable for the company’s resources. They must use these resources efficiently and effectively to produce profits or other benefits for the owners. Owners need to be able to assess the performance of the directors so that they can decide whether to reappoint them or discharge them and how much they should be paid.

3.2 Users of financial statements and accounting information

A business should produce information about its activities because there are various groups of people who want or need to know that information.

Large businesses are of interest to a greater variety of people and so we will consider the case of a large public company, whose shares can be purchased and sold on a stock exchange.

The following people are likely to be interested in financial information about a large company with listed shares:

(a) Managers of the company appointed by the company’s owners to supervise the day-to-day activities of the company. They need information about the company’s financial situation as it is currently and as it is expected to be in the future. This is to enable them to manage the business efficiently and to make effective decisions.

(b) Shareholders of the company, i.e. the company’s owners, want to assess how well the management is performing. They want to know how profitable the company’s operations are and how much profit they can afford to withdraw from the business for their own use.

(c) Trade contacts include suppliers who provide goods to the company on credit and customers who purchase the goods or services provided by the company. Suppliers want to know about the company’s ability to pay its debts; customers need to know that the company is a secure source of supply and is in no danger of having to close down.

(d) Providers of finance to the company might include a bank which allows the company to operate an overdraft, or provides longer-term finance by granting a loan. The bank wants to ensure that the company is able to keep up interest payments, and eventually to repay the amounts advanced.

(e) The taxation authorities want to know about business profits in order to assess the tax payable by the company, including sales taxes, for example Goods and Services Tax or Value Added Tax.

(f) Employees of the company should have a right to information about the company’s financial situation, because their future careers and the size of their wages and salaries depend on it.

(g) Financial analysts and advisers need information for their clients or audience. As examples, stockbrokers need information to advise investors; credit agencies want information to advise potential suppliers of goods to the company; and journalists need information for their reading public.

(h) Government and their agencies are interested in the allocation of resources and therefore in the activities of business entities. They also require information in order to provide a basis for national statistics.

(i) The public. Companies affect members of the public in a variety of ways. They may make a substantial contribution to a local economy by providing employment and using local suppliers. Another important factor is the effect of an entity on the environment as an example in relation to pollution.

Accounting information is summarised in financial statements to satisfy the information needs of these different groups. These information needs will differ between each user group and not all will be equally satisfied.
3.3 Needs of different users

Managers of a business need the most information, to help them make their planning and control decisions. They obviously have 'special' access to information about the business, because they are able to demand whatever internally produced statements they require. When managers want a large amount of information about the costs and profitability of individual products, or different parts of their business, they can obtain it through a system of cost and management accounting.

Question 2: Information for managers

Which of the following statements is most likely to be useful for managers rather than for other users of financial information?

A  financial statements for the last financial year  
B  tax records for the past five years  
C  budgets for the coming financial year  
D  bank statements for the past year

(The answer is at the end of the chapter)

In addition to management information, financial statements are prepared, and often published, for the benefit of other user groups, which may demand certain information:

(a) The national laws of a country may provide for the provision of some accounting information for shareholders and the public.

(b) National taxation authorities will receive the information they need to make tax assessments.

(c) A bank might demand a summary of a company's last few years of financial statements as a pre-condition of granting an overdraft or loan.

(d) The IASB has been responsible for issuing IFRS and International Accounting Standards (IAS) and these require companies to publish certain additional information. Accountants, as members of professional bodies, are placed under a strong obligation to ensure that listed company group financial statements conform to the requirements of IFRS/IAS.

(e) Some companies provide, voluntarily, specially prepared financial information for issue to their employees. These statements are known as 'employee reports'. In Australia for example, public companies will generally provide employees with a summary of the financial results and key issues from the annual report via e-mail or letter. Such reports are also common in the UK.

As we have already seen, unlike managers, other user groups are external to the business. Therefore they normally have to rely on published financial statements to provide them with the information that they need. In most developed countries, including Australia, financial statements are primarily prepared to meet the information needs of the groups that provide finance to a business: existing and potential investors and lenders and their advisors.

4 The need for financial accounting systems

Section overview

- A financial accounting system is the data, records and procedures that a business uses to prepare, provide and report financial information to its stakeholders.
- An accounting system records, classifies and summarises transactions to produce the financial statements
- It also provides internal control: procedures to check the accuracy of the accounting records, prevent errors and safeguard the entity's assets.

4.1 Introduction

Definition

A financial accounting system, is the data, records and procedures that a business uses to prepare, provide and report financial information to its stakeholders.
In order to produce financial statements, a business must keep a record of all the transactions that it makes, the assets it acquires and liabilities it incurs. When the time comes to prepare the financial statements, the relevant information is taken from those records.

A business records transactions, assets and liabilities:

(a) In chronological order, dated so that transactions can be related to a particular period of time.

(b) Built up in cumulative totals:

   (i) Day-by-day (e.g. total sales on Monday, total sales on Tuesday).
   (ii) Week by week.
   (iii) Month by month.
   (iv) Year by year.

4.2 Recording, classifying and summarising transactions

An accounting system does not only identify and record transactions and measure their monetary value. In order to produce financial statements an entity must process large numbers of transactions or other events and aggregate them into classes according to their nature or function. These classes must then be summarised to produce financial statements and other information for management.

The exact way in which an entity’s accounting system is organised depends on the type of business it conducts and the specific transactions that it enters into. No two businesses are exactly the same.

However, most entities maintain certain accounting records. You may be familiar with these from your earlier studies:

- Transactions are initially recorded in books of prime entry. These may be manual or (more probably) computerised and generally include the following:
  (a) Sales day book and sales returns day book.
  (b) Purchase day book and purchase returns day book
  (c) Journal
  (d) Cash book and petty cash book

- Entries in the books of prime entry are totalled at regular intervals. These totals are then posted to the relevant account in the general ledger (sometimes called the nominal ledger or the main ledger).

- The journal records transactions which are not recorded in any of the other books of prime entry.

- The general ledger is organised so that it analyses groups of transactions into meaningful categories. The list of balances in the general ledger is the starting point for the preparation of the annual financial statements.

4.3 Internal control

Definition

Internal control, is the system of controls that an entity establishes in order to provide reasonable assurance of the safeguarding of assets against unauthorised use or disposal, the maintenance of proper accounting records and the reliability of financial information used within the business or for publication.

Another important function of an accounting system is to provide internal control. The owners and managers of a business need to be reasonably certain that the accounting records are free from serious errors and that the financial statements, management accounts and other information produced from them is reliable. They also need to ensure, as far as possible, that the business’s assets are safeguarded from theft or other misuse.

An entity’s accounting system should include procedures to check the accuracy of the accounting records and to detect errors. Basic accounting procedures normally include:

- Reconciliation of the cash book balance to the balance on the entity’s bank statement (bank reconciliations)
• Reconciliation of the balances on the trade receivables and trade payables accounts in the general ledger to the total of the individual balances owed by customers and the total of the individual balances owed to suppliers (control account reconciliations)

• Physical counts of tangible assets such as computer equipment, motor vehicles, inventories and petty cash.

Non-financial control procedures are discussed in the next section.

5 Control over business transactions

Section overview

• Accounting systems do not operate in isolation but are part of the broader business system known as the management information system
• Control procedures should be in place throughout the system

5.1 Introduction

This section of the chapter examines the role that business systems as a whole have to fulfil in recording and reporting information about an organisation’s activities. Accounting systems do not operate in isolation but are one part of the broader business system.

There are a number of areas or functions to be administered and managed within a business. As an example, the ‘head office’ of a business may cover the following areas:

• Purchasing
• Human resources
• Finance
• Sales and marketing
• General administration

5.1.1 Purchasing

Whether a business manufactures products or sells bought-in products, there will be a large purchasing function, either purchasing raw materials for manufacture or purchasing finished goods for resale. The function of the purchasing department will be to ensure that the business purchases from suppliers providing the best overall deal in terms of price, service, delivery time and quality. The purchasing department will also be responsible for ensuring that only necessary purchases are made by the business.

5.1.2 Human resources

Any business that employs a significant number of people is likely to have a human resources function. This area of the office will be responsible for taking on new staff and for terminating the employment of other staff, for training of staff and for the general welfare of the employees.

5.1.3 Finance

The finance function is also very wide-ranging. On a day-to-day level the accounts department will deal with the sending of invoices to customers, receiving invoices from suppliers, payment of suppliers, receiving money from customers and making other payments such as purchases of non-current assets and payment of employees. The higher levels of management in the accounting function may also be responsible for management of the cash balances and for the overall financing of the organisation.

5.1.4 Sales and marketing

The selling and marketing function will deal with all aspects of taking sales orders, advertising, and any sales personnel.

5.1.5 General administration

General administration functions are very wide-ranging but might include secretarial support, dealing with telephone queries and arranging matters such as rent of properties.
**Question 3: Departmental functions**

Which of the following is not a function of the purchasing department?

A. ensuring that only required goods are purchased
B. ensuring that suppliers used give the best price
C. paying suppliers' invoices
D. negotiating discounts with suppliers  

(The answer is at the end of the chapter)

---

**5.2 Policies**

As you will be starting to realise, in any reasonable-sized business there will be a lot of different transactions and roles being carried out by many different people in the organisation. In any entity, there will have to be some form of rules and procedures to enable management to keep control of the activities.

For example, there must be **authorisation policies** for the purchase of non-current assets, procedures for choosing new suppliers and procedures for accepting new customers.

In smaller organisations where only a handful of individuals are involved in the transactions of the business such procedures and best practices can be **communicated orally by management**. However, in larger organisations where there are very many people carrying out functions possibly at a number of different geographical locations, then a more formal procedure is needed to ensure that the correct procedures and practices are followed.

This often takes the form of a **policy manual** which will set out the required procedures for all of the various functions of the business. Every employee will be expected to have read the areas relevant to their functions and the policy manual should always be readily available for easy reference.

Although a policy manual is recommended as a form of control over the activities of employees, care must be taken that strict adherence to the rules does not create inflexibility and in cases of doubt, a more senior member of the staff should be consulted.

**5.3 Business transactions**

It was explained earlier that businesses come in all shapes and forms. However, there will be a number of types of transactions which will be common to most businesses:

- Making sales.
- Paying employees.
- Making purchases.
- Purchasing non-current assets.
- Paying expenses.

The financial accounting system is an important part of the business function and forms part of the transactions described above. As we noted earlier in this chapter, the system has to be designed to capture all relevant information needed to record the business transactions and to ensure that the organisation's assets and liabilities are correctly recorded.
This diagram shows, in a simplified form, the flow of funds, documentation and information.

Effective systems and procedures should ensure that:

- Relationships with customers are effectively managed.
- Relationships with suppliers are effectively managed.
- Office functions interrelate properly and are not duplicated.

Within the overall system, which we can consider to be how each department relates to the other departments and to outside bodies, there will be sub-systems. For instance, the purchasing department function will have its own system, which will be designed to ensure that only authorised payments are made, that no invoice ever gets paid twice and that expenses are coded to the correct accounts.

Weaknesses in office procedures may be signalled by:

- Arguments over job functions.
- Disputes with customers/suppliers.
- Missing paperwork.
- Goods not delivered.

### 5.3.1 Sales

In a retail organisation sales are, of course, made on the shop floor. However, in a manufacturing organisation there will normally be a sales and marketing function whose responsibility it is to market the organisation’s products and take orders from customers. Often the day-to-day responsibility for taking orders will be with the sales team. This may be done over the telephone or may be via personal visits to customers or potential customers.

If a sale is being made to an existing customer, provided that customer has not exceeded their credit balance, then the procedure will be for the sales person to take details of the order and pass those details to the stores department for despatch and to the accounts department for invoicing of the customer.

However, if the sale is to a new customer then a more senior level of management will have to be involved if the sale is to be made on credit terms. The credit status of the new customer must be determined and a decision made as to whether sales on credit terms should be allowed to this customer.

Once the goods have been despatched to the customer responsibility then passes to the accounting function to invoice the customer for the goods and to ensure that payment is received.
5.3.2 Purchases

The making of purchases will initially be started by either the purchasing department or the stores department. The need for the purchase of more goods will be recognised by, for example, the stores manager when he realises that an item of inventory is running low. He will then complete a purchase requisition which must be authorised and then the purchasing department will determine the most appropriate supplier on the basis of price, delivery and quality. An order will be placed by the purchasing department and the goods will normally be received by the stores department.

After this, responsibility then goes to the accounting department which will await the arrival of the invoice for the goods from the suppliers. They will also check that the invoice is accurate and is for goods that have in fact been received and then in due course pay the amount due to the supplier.

In a service organisation there will be no purchases of materials or goods for resale but there will still be purchases of stationery and other office items which must be controlled.

5.3.3 Overheads

Organisations will incur a variety of expenses such as rent and rates, insurance, telephone bills, energy bills and advertising expenses. In some cases these will be incurred by a specific department of the business such as the marketing department investing in an advertising campaign or alternatively the receipt of the telephone bill will be part of the general administration of the business.

When invoices for expenses are received they will be passed to the accounting department which will check that the expense has been incurred or is reasonable and then will process the expense for payment.

5.3.4 Payroll

For every relevant pay period (eg week and/or every month) the employees of the business must be paid. For this process to take place there are a lot of calculations to be made and a lot of paperwork to be filled out. In larger organisations there will be payroll department which will deal with this, otherwise it will be the responsibility of the payroll clerk in the accounting department.

The payroll function will determine the gross pay for each employee, based upon a number of different remuneration schemes, and then will calculate the statutory and other deductions that must be made and the net pay due to the employee. Finally the payroll function must then organise the method of payment to the employees.

5.3.5 Capital expenditure

From time to time an organisation will need to purchase non-current assets. These are assets that are intended to be used in the business for the medium to long term rather than being purchased for quick/immediate resale. This will include items such as machinery, cars, computer equipment and office furniture.

In order for the purchase of non-current assets to be put in motion the manager of the department which requires the asset must first fill out a purchase requisition. As most non-current assets are relatively expensive this will probably have to be authorised by more senior management. Once the requisition has been authorised the purchasing department will then find the most appropriate supplier for the assets.

Once a purchase order has been placed the details will then be passed to the accounting department which will then process and pay the invoice when it is received.

Question 4: Purchasing function

Which of the following personnel in an organisation would not be involved in the purchase of materials?

A credit controller  
B stores manager  
C accountant  
D purchasing manager  

(The answer is at the end of the chapter)

5.4 Control over transactions

In the last section you will have seen that any transaction that a business is engaged in will tend to involve a number of different people within the organisation. You will have also noticed the requirement for transactions to be authorised.
The management of a reasonably large business does not have the time to personally be involved in every transaction of the business. However, in order to keep control of the sources of income and expenditure of the business, it is important that transactions are authorised by a responsible member of the management team.

In particular, this means that management must have control over the following areas:

(a) **Sales on credit made to new customers.** If a sale is made on credit the goods are sent out with a promise from the customer to pay in the future. Therefore, the management of the business must be as certain as they can be that this new customer can, and will, pay for the goods. This means that the credit controller must be satisfied that the new customer has a good credit rating and is quite certain to pay for the goods.

(b) **Purchases of goods or non-current assets and payments for expenses.** This is money going out of the business, therefore it is essential that these are necessary and valid expenditures so a responsible staff member must authorise them.

(c) **Payroll.** One of the largest payments made by most organisations is that of the wages bill for their employees. It is essential that only *bona fide* employees are paid for the actual hours that they have worked, therefore authorisation of the payroll is a very important part of any business.

### 5.5 Financial control procedures

Financial control procedures exist specifically to ensure that:

- Financial transactions are properly carried out.
- The assets of the business are safeguarded.
- Accurate and timely management information is produced.

These are some examples of financial control procedures:

- Cheques above a certain amount need two signatories.
- Authorisation limits for purchase orders.
- Authorisation is required for petty cash and expenses claims.
- Effective credit control procedures exist.
- Computer security procedures and access levels.

Weaknesses in financial control procedures may be signalled by:

- Cash or cheques going missing.
- Excessive bad or doubtful receivables balances.
- Customers not paying within credit terms.
- Suppliers not being paid on time.
- Unauthorised purchases being made.
- Failure to produce accounts or other reports at the specified time.

### 6 Manual and computerised accounting systems

**Section overview**

- In many situations manual systems are inferior to computerised systems in terms of productivity, speed, accessibility, quality of output, incidence of errors, ‘in bulk’ and when making corrections.

Most accounting systems are computerised and anyone training to be an accountant should be able to work with them. The most important point to remember is that the *principles* of computerised accounting are the same as those of *manual accounting*.

Most references to computerised accounting talk about accounting *packages*. This is a rather general term, but most of us can probably name the accounting package that we use at work. An accounting package consists of several accounting *modules*, e.g. receivables ledger, general ledger.
6.1 Accounting packages

Accounting functions retain the same names in computerised systems as in more traditional written records. Computerised accounting still uses the familiar ideas of journals, ledger accounts, double entry, trial balance and financial statements. The principles of working with computerised sales, purchase and nominal ledgers are the same as what would be expected in the manual methods they replace.

The only difference is that these various books of account have become invisible. Ledgers are now computer files which are held in a computer-sensible form, ready to be called upon.

6.2 Manual systems versus computerised systems

Disadvantages of manual systems include the following:

<table>
<thead>
<tr>
<th>Disadvantage</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Productivity</td>
<td>Productivity is usually lower, particularly in routine or operational situations such as transaction processing.</td>
</tr>
<tr>
<td>Slower</td>
<td>Processing is slower where large volumes of data need to be dealt with.</td>
</tr>
<tr>
<td>Risk of errors</td>
<td>The risk of errors is greater, especially in repetitive work like payroll calculations.</td>
</tr>
<tr>
<td>Less accessible</td>
<td>Information on manual systems is generally less accessible. Access to information is often restricted to one user at a time.</td>
</tr>
<tr>
<td>Alterations</td>
<td>It is difficult to make corrections. If a manual document contains errors or needs updating it is often necessary to recreate the whole document from the beginning.</td>
</tr>
<tr>
<td>Quality of output</td>
<td>Quality of output is less consistent and often not well-designed. At worst, hand-written records may be illegible and so become completely useless.</td>
</tr>
<tr>
<td>Bulk</td>
<td>Paper-based systems are generally very bulky both to handle and to store.</td>
</tr>
</tbody>
</table>

7 The information provided by financial accounting systems

Section overview

- An entity’s financial accounting system should be designed so that it can be used to produce financial information that is useful to both management and users external to the business.

Earlier in the chapter we noted that a financial accounting system should be designed to correctly record the business transactions and the organisation’s assets and liabilities. We also noted that an accounting system aggregates individual transactions so that they are grouped into meaningful categories. This information is summarised to produce financial reports: general purpose financial statements for use by providers of finance and other users external to the business; and special purpose reports including management accounts and other information for users within the business.

7.1 Information for management

Managers require information that will help them to make decisions about planning and controlling the business and about its general strategic direction. This may include:

- Monthly or quarterly accounts for the business as a whole
- Reports that show the performance of each part of the business (e.g. by division, product type, profit centre, geographical location)
- Budgets and forecasts
- Costing reports
- Information about the profitability of individual products
Unlike general purpose financial statements, management information can be produced quarterly, monthly or weekly, depending on the needs of managers. As they are for internal use only, management reports can be presented in any form that management wishes. In larger businesses, reports may be tailored to the specific decision that is being made and may include/consider:

- Sensitivity analysis
- Desirability of investments
- Competitors’ performance
- Evaluation/analysis of alternative options
- Non-financial information

Some large businesses may use a separate accounting system for management information. However, many businesses use the same accounting system to produce both management accounts and the published financial statements.

### 7.2 The general ledger

The general ledger should be organised in such a way that it can be used to produce all the information that management needs. Most entities use a computerised general ledger which assigns a code to each individual account. An entity should have a comprehensive and systematically arranged list of named and numbered ledger accounts (sometimes known as a chart of accounts). The code normally has several digits, for example:

- Administrative expenses
  - Office salaries
    - Office salaries: Head office
    - Office salaries: Northern Territory
    - Office salaries: Western Australia

Management can request reports of total administrative expenses for a period; total administrative expenses analysed by type of expenditure; and administrative expenses analysed by type of expenditure and location. If (for example) it is more important to be able to analyse administrative expenses by location or division than by type, the accounts should be coded accordingly.

#### Question 5: Management reports

A medium sized construction company carries out two main types of operation: buildings and roads. It completes about thirty separate contracts each year.

What information about revenues and costs is management likely to need?

*(The answer is at the end of the chapter)*

### 7.3 Information for external users

Shareholders, lenders and other external users must normally rely on the published financial statements to meet their information needs.

IAS 1 *Presentation of financial statements* explains the process of preparing financial statements from the accounting records:

‘Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements.’

Published financial statements must normally comply either with international or national accounting standards. This means that the accounting system must be able to produce the information that is required by accounting standards and/or by legislation. This includes disclosure notes, as well as particular line items in the financial statements.
Question 6: Financial performance

Various accounting standards require a reporting entity to disclose useful information about its financial performance. An example of a statement of financial performance is shown below.

### Income Statements

<table>
<thead>
<tr>
<th></th>
<th>Consolidated</th>
<th>Woolworths Limited</th>
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<tbody>
<tr>
<td></td>
<td>2010</td>
<td>2009</td>
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<tr>
<td></td>
<td>52 weeks</td>
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#### Note

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<th>2010</th>
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</tbody>
</table>

| Revenue from the sale of goods | 2a | 51,694.3 | 49,594.8 | 37,006.9 | 35,607.0 |
| Other operating revenue      | 2e | 90.5     | 103.0    | 81.0     | 84.4     |
| Revenue from operations      |    | 51,784.8 | 49,697.8 | 37,088.7 | 35,691.4 |
| Cost of sales               | (38,391.2) | (36,974.4) | (27,460.6) | (26,586.1) |

| Gross profit                | 2b | 13,393.6 | 12,723.4 | 9,628.1 | 9,105.3 |
| Other revenue               |    | 179.3    | 148.4    | 117.1   | 97.0    |
| Branch expenses             | (8,165.4) | (7,800.4) | (5,651.9) | (5,381.8) |
| Administration expenses     | (2,325.4) | (2,255.9) | (1,861.0) | (1,853.8) |
| Earning before interest and tax | 3,082.1 | 2,813.3 | 2,232.3 | 1,960.7 |

| Financial expense | 3 | (238.5) | (252.2) | (233.9) | (226.9) |
| Financial income   | 3 | 27.0    | 46.0    | 74.1    | 314.8   |
| Net financing (cost)/benefit | (211.5) | (189.2) | 40.2    | 87.9    |

| Net profit before income tax expense | 5a | 2,870.6 | 2,626.3 | 2,272.5 | 2,054.6 |
| Income tax expense         | (832.6) | (766.3) | (655.3) | (606.3) |

| Profit after income tax expense | 5a | 2,038.0 | 1,860.0 | 1,617.2 | 1,448.3 |

| Net profit attributable to: |
| Equity holders of the parent entity | 2,020.8 | 1,835.7 | 1,617.2 | 1,448.3 |
| Non-controlling interest         | 17.2    | 72.7    | –       | –       |

| Earning per share (EPS)         |
| Basic EPS (cents per share)     | 20 | 164.01  | 150.71  | –       | –       |
| Diluted EPS (cents per share)   | 20 | 163.17  | 149.69  | –       | –       |
| Weighted average number of shares used in the calculation of basic EPS (million) | 20 | 1,232.1 | 1,218.0 | –       | –       |

What other different types of information about performance might be provided in published financial statements? (Note: this question can be answered without any detailed knowledge of IAS or IFRS).

(The answer is at the end of the chapter)

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**Case study: Limited company financial statements**

Examine as many sets of limited company financial statements as you can. If possible, look at the annual financial statements of smaller companies, as well as published annual reports available on the internet.

As you do so, think about the information disclosed in them and why it might be useful to particular groups of users.
Accounting is the process of recording, analysing and summarising transactions of a business and communicating that information to decision makers.

A business is an entity which exists to make a profit.

There are three main types of business entity: sole traders, partnerships and limited liability companies.

Non-commercial undertakings such as charities and clubs will also prepare accounts.

You should be able to distinguish between financial and management accounting.

There are various groups of people who need information about the activities of a business.

A financial accounting system is the data, records and procedures that a business uses to prepare, provide and report financial information to its stakeholders.

An accounting system records, classifies and summarises transactions to produce the financial statements.

It also provides internal control: procedures to check the accuracy of the accounting records, prevent errors and safeguard the entity’s assets.

The accounting systems do not operate in isolation but are part of the broader business system.

Control procedures should be in place throughout the system.

In many situations manual systems are inferior to computerised systems in terms of productivity, speed, accessibility, quality of output, incidence of errors, ‘in bulk’ and when making corrections.

An entity’s financial accounting system should be designed so that it can be used to produce financial information that is useful to both management and users external to the business.
Quick revision questions

1 What is the main aim of accounting?
   A to maintain ledger accounts for every asset and liability
   B to provide financial information to users of such information
   C to produce a trial balance
   D to record every financial transaction individually

2 The primary purpose of a business is to make a profit. Which of the following entities will exist primarily to make a profit?
   A a children’s charity
   B a local hospital
   C a community scout group
   D a small grocery shop

3 What type of financial information would a management accountant prepare?
   A annual financial statements
   B company budgets
   C environmental report
   D chairman’s report

4 Which of the following groups of users would primarily be interested in a company’s annual published financial statements?
   A management and employees
   B shareholders and suppliers
   C shareholders and providers of finance
   D general public, environmental pressure groups

5 Which of the following entities would need a business system which included finance, sales and marketing, human resources, purchases and administration functions?
   A an accountant working as a sole trader
   B two lawyers working in partnership together
   C a multinational corporation
   D a retail organisation employing eight people

6 The business entity concept requires that a business is treated as being separate from its owners. Is this statement true or false?
   A true
   B false

7 An organisation has to decide whether to buy or lease machinery for its new factory. Which of the following members of the finance function would be responsible for this decision?
   A the financial manager
   B the management accountant
   C the financial accountant
   D the credit controller

8 Goods inwards checks are an example of a control in which business financial system?
   A payroll
   B purchasing
   C sales
   D cash management
9 A computerised accounting system operates using the principle of double-entry accounting. Is this statement true or false?
A true
B false

10 Which of the following is an advantage of a manual system of accounting as opposed to a computerised system?
A processing of transactions is faster
B it is unlikely that calculation errors may be made
C minimal storage of documents is required
D there is less chance of system outages stopping work
1 B The primary aim of accounting is to provide financial information for users.

2 D The shop is the only business entity, the remainder are all non-profit making entities and exist to fulfil a particular aim rather than to earn profits.

3 B Management accountants produce financial information that is useful to the management of an organisation, such as budgets. Financial accountants generally produce the financial statements, and the directors produce various narrative reports.

4 C Lenders and shareholders in particular are identified as the primary users of financial statements. Information produced with them in mind should also be useful for other user groups, however these other groups are not considered to be the main audience of financial accounts.

5 C Neither a sole trader nor a partnership with no employees need human resource functions and therefore A and B are discounted. A retail organisation does not need a sales function and therefore D is discounted. A multinational organisation needs all of the functions mentioned and possibly others.

6 A The business entity concept means that a business is treated as being separate from its owners.

7 A The financial manager is responsible for raising finance and controlling financial resources. The management accountant presents accounting information to support the management of the business. The financial accountant reports the results and financial position of a business.

8 B Purchasing-system tests are based around buying and goods inwards. The equivalent for sales would be selling and goods outwards. Payroll concerns the payment of wages and salaries. Cash management focuses on the authorisation, verification and recording of payments and receipts.

9 A Although the double entry system may not be as visually apparent as it is in a manual system, it still underpins accounting, regardless of the method of data capture.

10 D When a computerised system suffers a technical problem, work can not continue until the problem is corrected.
1  B  Financial reporting is carried out by all businesses, no matter what their size or structure.
2  C  Managers need to look forward and make plans to keep the business profitable. Therefore the most useful information for them would be the budgets for the coming financial year.
3  C  Paying suppliers’ invoices.
4  A  The credit controller follows up unpaid debts.
5  
   • Sales revenue, direct costs, overheads and profits for each of the two main operations
   • Sales revenue, direct costs, overheads and profits for each individual contract
   • Direct costs and overheads analysed by each type of expenditure (eg, raw materials, direct labour, etc)

This information will probably be compared with budgets or estimates and/or amounts for the previous year(s).
6  Information about performance:
   • Analysis of revenue and profit from operations by business segment (class of business and/or geographical location) (required by IFRS 8 Operating segments)
   • Disclosure of unusual or material expense items (required by IAS 1 Presentation of financial statements)
   • Revenue, expenses and pre-tax profit of any operations that were discontinued during the year (required by IFRS 5 Non-current assets held for sale and discontinued operations)
   • Significant accounting policies adopted (required by IAS 1 Presentation of Financial Statements)
   • Notes analysing finance expense and income and the income tax expense.
   • Five year summaries of sales by business segment and earnings before interest and tax
   • Other information relevant to the business (e.g. Woolworths discloses details of the number of stores opened and closed in the period and sales per square metre of supermarket)
Chapter 2
The regulatory framework

<table>
<thead>
<tr>
<th>Learning objectives</th>
<th>Reference</th>
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<tbody>
<tr>
<td>The regulatory framework</td>
<td>LO2</td>
</tr>
<tr>
<td>Define what is meant by the regulation of published financial statements</td>
<td>LO2.1</td>
</tr>
<tr>
<td>Identify the different sources of accounting regulation including company law, local GAAP and IFRS</td>
<td>LO2.2</td>
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<tr>
<td>Describe the advantages and disadvantages of regulating financial statements</td>
<td>LO2.3</td>
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<td>Identify why regulatory regimes may vary between different countries</td>
<td>LO2.4</td>
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<tr>
<td>Describe the role of the International Accounting Standards Board (IASB) in the regulation of financial statements</td>
<td>LO2.5</td>
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<tr>
<td>Explain the need for International Financial Reporting Standards as a global means of regulating accounting</td>
<td>LO2.6</td>
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<tr>
<td>Describe the benefits of international accounting standards for national jurisdictions</td>
<td>LO2.7</td>
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Topic list

1. The need for a regulatory framework
2. The IFRS Foundation and the IASB
This chapter is concerned with the different sources of accounting regulation. Accounting is regulated by local statute (such as company law), by stock exchange requirements and by accounting standards. We will look at the sources of regulation and focus in particular on the activities of the International Accounting Standards Board (IASB) which is responsible for setting IFRS.

We will also discuss the importance of IFRS in the global regulation of accounting and the process the IASB undertakes in issuing a new accounting standard.
Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

1. What is GAAP? (Section 1.2)
2. Which of the following are advantages of having a regulatory system of accounts? (Section 1.3)
   - I. Increased public confidence in financial statements
   - II. Enhanced comparability between financial statements
   - III. The development of rules which are applicable to all entities
   - IV. The disclosure of more useful information than if there were no regulations
   A. I, II and IV only
   B. I and IV only
   C. II, III and IV only
   D. I, II, III and IV

3. What is the IASB and what are its objectives? (Sections 2.1 and 2.3)
4. What is the IFRS Advisory Council and what is its purpose? (Section 2.4)
5. What is the IFRSIC and what is its purpose? (Section 2.4)
6. What is meant by a ‘true and fair view’? (Section 2.8)
1 The need for a regulatory framework

1.1 Introduction

The regulatory framework is the most important element in ensuring that general purpose financial reporting produces relevant and reliable information and therefore meets the needs of shareholders, lenders and other users.

There would be no means of enforcing compliance with GAAP without a single body with overall responsibility for producing financial reporting standards (the IASB) and a framework of general principles within which they can be produced (the Conceptual Framework). Also, GAAP would be unable to evolve in any structured way in response to changes in economic conditions.

The regulation of financial statements refers to the existence of a framework which consists of accounting rules and company law to ensure that companies follow the required rules in the preparation of their financial information. The benefits of this are that financial information is prepared on a consistent basis and can be used for comparison with other entities. As international financial reporting standards have no jurisdiction, and the IASB has no authority to impose accounting standards, regulation typically takes place on a national basis, with governments often adopting IFRS as the accounting standards to be used and then complementing them with local laws and regulations as necessary.

1.2 Generally Accepted Accounting Principles (GAAP)

GAAP signifies all the rules, from whatever source, which govern accounting.

In individual countries this is seen primarily as a combination of:

- National company law.
- National accounting standards.
- Local stock exchange requirements.

Although these sources are the basis for the GAAP of individual countries, the concept also includes the effects of non-mandatory sources such as:

- International accounting standards.
- Statutory requirements in other countries.

In many countries, GAAP does not have any statutory or regulatory authority or definition. There are different views of GAAP in different countries. The IASB convergence program seeks to reduce these differences.

GAAP can be based on legislation and accounting standards that are either:

(a) prescriptive / rules-based; or
(b) principles-based.

The US operates a prescriptive system, where standards are very detailed, attempting to cover all eventualities. Accounts which do not comply in all details are presumed to be misleading. This has the advantage of clear requirements which can be generally understood and it removes any element of judgment.

In general, international accounting standards (IFRS and IAS) are principles-based. They do not specify all the details but seek to obtain adherence to the ‘spirit’ of the regulations. This leaves room for some element of professional judgment. It also makes it harder for entities to avoid applying a standard as the terms of reference are broader. (We will be discussing the differences between rule based standards and principles based standards in more detail in Chapter 4.)

1.2.1 Individual judgment

Financial statements are prepared on the basis of a number of fundamental accounting assumptions and conventions. Many figures in financial statements are derived from the application of judgment in putting these assumptions into practice.

It is clear that different people exercising their judgment on the same facts can arrive at very different conclusions.
**Question 1: Judgment**

An accountancy training firm has an excellent **reputation** amongst students and employers. How would you value this? The firm may have relatively little in the form of assets that you can touch, perhaps a building, desks and chairs. If you simply drew up a statement of financial position showing the cost of the assets owned, then the business would not seem to be worth much, yet its income earning potential might be high. This is true of many service organisations where the people are among the most valuable assets. Here judgment must be used in order to reach a valuation for the business, although one person’s judgment may lead to a very different valuation from another person’s.

Can you think of any areas where judgment would have to be used in preparing financial statements?

*(The answer is at the end of the chapter)*

### 1.3 Advantages and disadvantages of regulation

**The key benefit of accounting regulation is that it requires organisations to prepare financial statements on a consistent basis.** This is useful for the users of financial statements that were identified in Chapter 1. For example, an investor wishing to purchase shares in a company is able to compare that company’s performance with another, as their financial statements should have been prepared on the same basis.

Other **advantages of regulation** include:

(a) The existence of accounting rules reduces variations in the way financial statements are prepared. Without regulation it would be possible for preparers to adopt whatever accounting treatments they choose and to vary these from year to year in order to present the company’s profit figure and net assets in as favourable a light as possible. In addition, transactions and businesses have become increasingly complex. There are many legitimate ways to present, measure and disclose items such as complex financial instruments, but the accounting treatment of these items needs to be comparable between different entities and over time.

(b) Regulation means there will be rules as to what should be disclosed which improves the quality of information produced. For example, IAS 1 *Presentation of financial statements* requires companies to disclose the accounting policies that they have followed, so that users can understand the judgments that preparers have made in arriving at the amounts in the financial statements. Financial statements must also include supporting notes which analyse and explain the main line items in the financial statements. Specific information that must be disclosed is set out in accounting standards and (in some cases) companies legislation.

(c) The existence of regulation is likely to ensure that companies disclose more information about their business activities and financial results than they may have done in the absence of such regulation. There is an argument that companies resist disclosing information unless they are required to do so. There are costs associated with providing financial information. Without regulation, management is likely to be unwilling to deliver ‘bad news’ or to provide information to competitors.

(d) Regulation of companies listed on stock exchanges means there are strict requirements in terms of reporting and disclosure and this is likely to protect investors. In many countries, such as the Australia, the US and the UK, systems of accounting regulation were originally developed as a response to high profile company failures and frauds in which many investors lost their savings.

(e) A strong system of regulation will increase public confidence in the published financial statements of companies. This is particularly important since there have recently been a number of high profile corporate failures contributed to by inappropriate accounting.

(f) Some users of financial statements (for example, major corporate investors and lenders) have the power to demand the information that they need. Other users (for example, small investors and individual members of the public) have not. Regulation protects those less powerful individuals and organisations and can therefore be seen as a social good.

**Disadvantages of regulation** include:

(a) Strict regulation could mean a lack of flexibility for some businesses. Sometimes companies have differing business environments. These companies may have to adopt accounting treatments that do
not properly reflect their financial performance and position and actually lessen the quality of the information that they provide. In this situation, it may be impossible for users to make meaningful comparisons between companies.

(b) Companies may incur **high costs** in complying with the regulatory rules which is a disadvantage for smaller companies as the cost of providing the information required may outweigh the benefits of that information. This is particularly relevant where companies have to comply with either US regulations or International Accounting Standards (full IFRS). Both systems are designed primarily to protect large institutional providers of finance to multinational organisations. The IASB has now developed a special standard for small and medium entities (the IFRS for SMEs) to lessen the regulatory burden on smaller entities.

(c) Detailed rules and regulations may mean that companies spend a great deal of time 'box-ticking' without considering the spirit of the regulation they are complying with. Information is provided because it is required, even though it is of little value. The problem can be particularly acute where preparers are required to make specific narrative disclosures, for example, about corporate governance or future prospects for the business. Users frequently complain about 'boiler plate' disclosures: general statements that could apply to any company and tell the reader nothing.

(d) Regulation leads to financial statements that contain **too much information** and this can obscure the overall picture that they present. The length and volume of company annual reports is steadily growing as the result of new accounting requirements and many commentators believe that published financial statements have become too complex for anybody other than a financial reporting expert to understand.

**Question 2: Creative accounting**

Creative accounting is the name given to accounting treatments which comply with all applicable accounting regulations but which have been deliberately manipulated to give a biased impression of a company’s performance or financial position. From the 1990s onwards, new or improved accounting standards were developed to prevent most of these practices.

Briefly describe TWO possible methods of ‘creative accounting’.

(The answer is at the end of the chapter)

### 1.4 Variations in regulatory regimes

Regulation of companies and their published financial information can vary significantly in different countries throughout the world. There are many reasons for these differences. In some cases it is due to differences in company structures, local culture and ownership patterns of companies.

#### 1.4.1 Company structure and ownership

A country where the majority of companies are **family owned** with few, if any, external shareholders outside of the family will need far less regulation than a country which is dominated by large **multinational corporations** with large numbers of shareholders, who have no connection to the business. Much of the regulation in the latter case would be to ensure that companies are **acting in the best interests** of shareholders. In many family companies, the shareholders and directors are the same family members, so they will already be acting in the best interests of the shareholders and will be concerned about the long-term future of the business.

#### 1.4.2 Level of development

The level of development of a nation also has an impact on its level of regulation. **Developing countries** are further behind in the process of setting standards and establishing regulatory regimes than industrialised nations.

For example, the break-up of the former USSR and the move in many Eastern European countries to free-market economies has created difficulties. It is likely that these countries will have to ‘catch up’ to international standards as their economies stabilise.

East Timor, a tiny nation in both territory and population, was officially accepted into the United Nations as a sovereign state in 2002 after a long-running battle for independence from Indonesia. A poor nation, it is
establishing systems for long-term political and economic stability but is still struggling with the problems facing many developing nations. It is party to international conventions and standards (including IFRS), but lags behind in implementation. Cambodia is another example of a Southeast Asian developing nation where conflict, repression and resulting economic instability means it is still ‘catching up’ with more industrialised nations in terms of regulation adoption and implementation. Fiji, one of the largest and economically strongest Pacific island nations, was suspended from both the Pacific Island Forum and the Commonwealth of Nations during 2009, with both suspensions currently remaining in force. Its current military dictatorship has not yet called democratic elections and is accused of political oppression and isolationism. Fiji’s political upheaval and isolationist tendencies means standard-setting and regulation is of low importance.

1.4.3 Different purposes of financial reporting

In some countries the purpose of preparing financial statements is solely for tax assessment, and therefore the accounting rules are often the same as the tax rules. In other countries, financial statements exist to provide information for investor decision-making. This will have an impact on the type of regulatory system in place.

1.4.4 Different user groups

Countries have different ideas about who the relevant user groups are and their respective importance. In the US investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile. In Australia, prominence is given firstly to consumers and then to investors and creditors.

2 The IFRS Foundation and the IASB

Section overview

The International regulatory framework consists of:

- The International Financial Reporting Standards Foundation (IFRS Foundation)
- The International Accounting Standards Board (IASB)
- The International Financial Reporting Standards Advisory Council (IFRSAC)
- The International Financial Reporting Standards Interpretations Committee (IFRSIC).

2.1 Introduction

The IFRS Foundation is an independent, not-for-profit private sector organisation working in the public interest. It was founded in March 2001 as the IASC Foundation as a not-for-profit corporation incorporated in the United States and is the parent entity of the IASB. In March 2010, the IASC Foundation changed its name to the IFRS Foundation to reflect more clearly what the Foundation does which is the publication and promotion of IFRS.

The governance and oversight of the IFRS Foundation and its standard-setting bodies rests with the Trustees. The Trustees are appointed for a renewable term of three years and must have an understanding of the issues relevant to the setting and development of IFRS but are not involved in a technical capacity. Six of the Trustees must be selected from the Asia/Oceania region, six from Europe, six from North America, one from Africa, one from South America and two from the rest of the world. The Trustees are publicly accountable to a Monitoring Board of public authorities.

The International Accounting Standards Board is an independent, privately-funded accounting standard setter based in London. It is a part of the International regulatory framework, reporting to the IFRS Foundation.

From April 2001 the IASB assumed accounting standard setting responsibilities from its predecessor body, the International Accounting Standards Committee (IASC).

The IASB has an important role to play in the regulation of financial information as it is responsible for issuing IFRS, which are then adopted for use in many different jurisdictions. Since 2001, almost 120 countries have required or permitted the use of IFRS in preparing financial information which makes the
IASB the most important accounting body worldwide. The remaining major economies have timelines in place for the move from national accounting standards to convergence with IFRS in the near future.

2.2 How the IASB is comprised

The IASB is an independent group of experts with a mix of recent practical experience of standard-setting, or of the user, accounting, academic or preparer communities. Members of the IASB are appointed by the Trustees of the IFRS Foundation.

At the time of writing the 15 full-time members of the IASB come from many different countries and have a diverse range of backgrounds. As part of the IFRS Foundation’s Constitution review, the decision was made to increase the membership of the IASB to 16 full-time members by 2012 and provide guidelines on geographical diversity. In order to ensure a broad international basis by July 2012, there will normally be four members from the Asia/Oceania region; four members from Europe; four members from North America; one member from Africa; one member from South America; and two members appointed from any area, subject to maintaining overall geographical balance.

The IASB is publicly accountable to a Monitoring Board of public capital market authorities. The IASB aims to be collaborative in its development of standards by engaging with the worldwide standard setting community as well as investors, regulators, business leaders and the global accountancy profession.

2.3 Objectives of the IFRS Foundation

The formal objectives of the IFRS Foundation are:

(a) To develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world’s capital markets and other users of financial information to make economic decisions.

(b) To promote the use and rigorous application of those standards.

(c) To take account of the needs of a range of sizes and types of entities in diverse economic settings.

(d) To promote and facilitate adoption of International Financial Reporting Standards (IFRSs).

2.4 Structure of the IFRS Foundation

The structure of the IFRS Foundation has the following main features:

(a) The IFRS Foundation oversees two main areas – the standard-setting process and the IFRS Advisory Council (previously known as the Standards Advisory Council).

(b) The standard-setting process consists of two bodies, the IASB (as discussed above) and the IFRS Interpretations Committee. The IASB has the sole responsibility for setting international financial reporting standards.

(c) The IFRS Interpretations Committee (previously known as the International Financial Reporting Interpretations Committee (IFRIC)) comprises 14 voting members drawn from a variety of countries and professional backgrounds. The IFRS Interpretations Committee provides timely guidance on the application and interpretation of IFRS. It deals with newly identified financial reporting issues not specifically addressed in IFRS, or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.

(d) The IFRS Advisory Council (previously the Standards Advisory Council) is the formal advisory body to the IASB and Trustees of the IFRS Foundation. It is comprised of a wide range of representatives from user groups, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups that are affected by and interested in the IASB’s work. Members of the Advisory Council are appointed by the Trustees. It meets three times a year to advise the IASB on a range of issues including the IASB’s agenda and work program.
2.5 The need for international standards

While the predecessor organisation of the IFRS Foundation was in existence since the 1970s, the development of International standards has grown in importance in the last ten years. As business and commerce became more global in nature, many interested parties began to understand the need for a common set of accounting standards. Until that point, many multinational companies prepared financial statements under a variety of GAAPs, which was costly. This also had an impact on the auditors of those financial statements and current and future investors. Companies with stock exchange listings in more than one jurisdiction had to prepare different sets of financial statements for each jurisdiction which was viewed as inefficient.

The original International Accounting Standards were deliberately drafted to be flexible and to allow choices. From the 1990s onwards it became increasingly clear that it was not enough to have a set of international standards with which most countries could comply. These standards had to be sufficiently rigorous to be acceptable to all stock exchanges, including those in the US.

The starting point for the rapid change of the last few years was the acceptance of international accounting standards for cross border listings by the International Organisation of Securities Commissions (IOSCO). International standards gained more prominence when the European Union decided that from 2005, the consolidated financial statements of companies in the member states would be prepared under international standards. IFRS became the global standards that were needed and since then many countries, including Australia and South Africa, have adopted IFRS as their national standards or have a program in place to adopt international standards in the near future.
There are several general benefits of harmonisation:

- **Investors and lenders**, both individual and corporate, need to be able to compare the financial results of different companies internationally as well as nationally in making investment decisions. Differences in accounting practice and reporting can prove to be a barrier to such cross-border analysis. Harmonisation of financial reporting benefits investors, lenders and their advisors, because it provides them with better quality information on which to base economic decisions. Users no longer have to understand several different national GAAPs or to incur the costs of adjusting financial statements in order to compare them with each other.

- Harmonisation benefits the global economy, because it makes it removes barriers to the flow of capital between countries. It is easier for businesses to expand into and raise finance in countries other than their own.

- Robust international financial reporting standards are also needed to protect investors and to restore public confidence in financial reporting following the recent failure of several banks (notably Lehman Brothers) and the resulting credit crunch and global financial crisis. One of the actions agreed upon by the G-20 leaders (finance ministers and central bank governors from the world’s largest economies), in their summit meetings after the crisis, was that the key global accounting standards bodies should work intensively towards the objective of creating a single set of high quality global standards.

A full list of countries adopting IFRS and their progress can be found on http://www.iasplus.com/country/useias.htm

Chapter 4 reviews the harmonisation process in more detail.

### 2.6 Benefits of IFRS for national jurisdictions

The advantages of IFRS described above apply to individual nations. If it is possible to compare the financial statements of an entity in one country with those of another entity located in a different country it becomes easier to do business with overseas companies. This benefits national economies, as well as the global economy.

In its 2002 policy statement International Convergence and Harmonisation Policy the Australian Accounting Standards Board listed the following additional benefits of adopting IFRS:

- increasing the understanding by foreign investors of Australian financial reports;
- reducing financial reporting costs for Australian multinational companies and foreign companies operating in Australia and reporting elsewhere;
- facilitating more meaningful comparisons of the financial performance and financial position of Australian and foreign public sector reporting entities; and
- improving the quality of financial reporting in Australia to best international practice.

There are a number of further potential benefits for national jurisdictions:

- Many developing nations who do not have the resources to develop and implement their own national standards can adopt IFRS as a full set of standards. This is perhaps more relevant since the issue of the IFRS for SMEs as previously the level of detail in standards and the amount of disclosure required was a barrier to adoption of IFRS in developing countries.

- It may be easier for national governments to control the activities of foreign multinational companies that carry out operations within their territory. These companies would not be able to 'hide' behind foreign accounting practices which are difficult to understand.

- Tax authorities may find it easier to calculate the tax liability of investors, including multinationals who receive income from overseas sources.

Many national standard setting bodies are experiencing a change in their role as IFRS have become more important. Many standard setters no longer develop and issue their own accounting standards and instead comment on the work of the IASB, the impact of new IFRS and changing existing IFRS on their home jurisdiction.
2.7 Other international influences

There are a number of other international bodies that have been involved in the recent trend of moving to IFRS. They are discussed briefly below.

2.7.1 IASB and the European Commission

The European Commission (EC) has acknowledged the role of the IASB in harmonising world-wide accounting rules and EC representatives attend IASB Board meetings and have joined Steering Committees involved in setting IFRS.

The EC has also set up a committee to investigate where there are conflicts between European Union norms and International Standards so that compatibility can be achieved. In turn, the IASB has used EC Directives in its work.

From 2005, all listed entities in member states have been required to use IFRS in their consolidated financial statements.

2.7.2 United Nations (UN)

The UN has a Commission and Centre on Transnational Reporting Corporations through which it gathers information concerning the activities and reporting of multinational companies. The UN processes are highly political and probably reflect the attitudes of the governments of developing countries towards multinationals. For example, there is an inter-governmental working group of ‘experts’ on international standards of accounting and reporting which is dominated by the non-developed countries.

2.7.3 International Federation of Accountants (IFAC)

The IFAC is a private sector body established in 1977 and which now consists of over 100 professional accounting bodies, including CPA Australia, from around 80 different countries. The IFAC’s main objective is to co-ordinate the accounting profession on a global scale by issuing and establishing International Standards on auditing, management accounting, ethics, education and training. The IFAC has separate committees working on these topics and also organises the World Congress of Accountants, which is held every five years.

2.7.4 Organisation for Economic Co-operation and Development (OECD)

The OECD was established in 1960 by the governments of 21 countries to ‘achieve the highest sustainable economic growth and employment and a rising standard of living in member countries while maintaining financial stability and, thus, to contribute to the world economy’. It now has 33 member countries.

The OECD’s aim is to bring together the governments of countries committed to democracy and the market economy from around the world to:

- Support sustainable economic growth
- Boost employment
- Raise living standards
- Maintain financial stability
- Assist other countries’ economic development
- Contribute to growth in world trade

The Organisation provides a setting where governments compare policy experiences, seek answers to common problems, identify good practice and coordinate domestic and international policies.

The OECD supports the work of the IASB but also undertakes its own research into accounting standards via ad hoc working groups. The OECD also produces its own corporate governance principles and other publications aimed at improving financial reporting, regulation and removing corruption.

2.7.5 Australian Accounting Standards Board (AASB)

The AASB has the following functions:

- to develop a conceptual framework for the purpose of evaluating proposed standards;
- to issue accounting standards under section 334 of the Corporations Act 2001;
- to formulate accounting standards for other purposes;
• to participate in and contribute to the development of a single set of accounting standards for worldwide use;

• to advance and promote the main objects of Part 12 of the Australian Securities and Investments Commission Act, which include reducing the cost of capital, enabling Australian entities to compete effectively overseas and maintaining investor confidence in the Australian economy.

The AASB’s mission statement is to:

• develop and maintain high-quality financial reporting standards for all sectors of the Australian economy; and

• contribute, through leadership and talent, to the development of global financial reporting standards and to be recognised as facilitating the inclusion of the Australian community in global standard setting.

The Australian process of harmonisation with IFRS has been to issue IFRS-equivalent standards, i.e. adopt the content of IFRS with minor changes made to refer to the Australian legislative environment. The audit report of a company’s financial statements states that they have been prepared in compliance with IFRS.

2.8 True and fair view / fair presentation

It is a requirement of national legislation in some countries that the financial statements should give a true and fair view of (or ‘present fairly, in all material respects’) the financial performance and position of the entity as at the end of the financial year. Despite this, the terms ‘true and fair view’ and ‘present fairly, in all material respects’ are not defined in accounting or auditing standards.

In some jurisdictions a company’s managers may depart from any of the provisions of accounting standards if these are inconsistent with the requirement to give a true and fair view. This is commonly referred to as the ‘true and fair override’. It has been treated as an important loophole in the law in different countries and has been the cause of much argument and dissatisfaction within the accounting profession. For example, it is not recognised in Australia, where it was removed from legislation in 1991. Australian regulators and bodies want the accounting standards (and the true and fair view being established by them) given primacy. In Australia therefore, directors will give additional information in order to comply with the true and fair view, as they cannot depart from any of the provisions of the accounting standards.

2.9 The IASB and current accounting standards

The IASB’s predecessor body, the IASC, had issued 41 International Accounting Standards (IASs) and on 1 April 2001 the IASB adopted all of these standards and now issues its own International Financial Reporting Standards (IFRS). So far thirteen new IFRS have been issued as well as the IFRS for SMEs. As part of the convergence process with the US FASB (see below), a number of amended standards are expected in the next few months.

From now on in this Study Manual we will use the phrase IFRS for all International Accounting Standards unless we are specifically discussing a particular IAS.

2.10 The IASB and FASB

The IASB and the US Financial Accounting Standards Board (FASB) have been working together since 2002 to achieve convergence of IFRS and US GAAP. A common set of high quality global standards remains a priority of both the IASB and the FASB. Both parties set out their agreement in a Memorandum of Understanding known as the Norwalk Agreement. Their work plan was set out in a roadmap for convergence which outlined their targets over the period up to 2008 (see also chapter 4).

In 2007, the US Securities and Exchange Commission (SEC) removed the necessity for a reconciliation between IFRS and US GAAP for non-US companies that were listed in the US providing their financial statements comply with IFRS.
In 2008, and again in 2010, the Memorandum of Understanding was updated, setting out the objectives for the period to 2011 in the convergence of US GAAP and IFRS. The IASB and the FASB set a June 2011 target date for those projects deemed to be most important, leaving those with a lesser degree of importance to be dealt with later. The following projects had been completed by June 2011:

- Business combinations
- Consolidation
- Derecognition of financial instruments
- Fair value measurement
- Financial statement presentation
- Joint ventures
- Post-employment benefits

The IASB and FASB are currently working on the following projects, which they expect to complete in the second half of 2011:

- Financial instruments
- Revenue recognition
- Leases
- Insurance contracts

The IASB is also involved in a joint project with the FASB to develop a common conceptual framework. This would provide a sound foundation for developing future accounting standards. The aim is that future standards should be principles-based and internationally-converged. This represents a movement away from the rules-based approach which has characterised US accounting standards.

The new framework will build upon the existing IASB and FASB frameworks and take into account subsequent developments.
Key chapter points

- The regulatory framework is the most important element in ensuring that general purpose financial reporting produces relevant and reliable information and therefore meets the needs of shareholders, lenders and other users.

- As the IASB has no power to regulate the use of IFRS, regulation takes place at a national level.

- The organisational structure for International financial reporting consists of:
  - The IFRS Foundation
  - The IASB
  - The IFRS Advisory Council
  - The International Financial Reporting Standards Interpretations Committee.

- There are a number of benefits of harmonisation including the facilitation of cross-border investment and financing.

- Bodies including the UN, OECD and AASB promote the use of IFRS.
Quick revision questions

1. One objective of the IASB is to promote the preparation of financial statements using the Euro. Is this statement true or false?
   A. true
   B. false

2. What happened in 2005 for listed companies in the EU?
   A. IFRS to be used for all financial statements
   B. IFRS to be used for consolidated financial statements
   C. financial statements to be presented in euros
   D. financial statements to be presented in US dollars

3. What are the objectives of the IASB?
   A. to enforce IFRS
   B. to issue IFRS

4. Which committee of the IASB aims to improve users' interpretation of IFRS?
   A. IFRS Advisory Council
   B. IFRS Foundation
   C. IFRS Interpretations Committee
   D. International Accounting Standards Committee

5. What is the correct definition of GAAP?
   A. national accounting standards and company law
   B. national accounting standards, stock exchange rules and company law
   C. international accounting standards, company law and stock exchange rules
   D. national accounting standards, international accounting standards, stock exchange rules and company law

6. Which of the following is an advantage of regulation of company financial statements?
   A. less disclosure of a company's activities in financial statements
   B. lower costs of producing financial information
   C. higher quality financial information is produced
   D. more financial information available for competitors

7. What is the name of the accounting standards issued by the IASB?
   A. International Accounting Standards
   B. Financial Reporting Standards
   C. International Financial Reporting Standards
   D. International Reporting Standards

8. With which body is the IASB currently undertaking a project for the harmonisation of IFRS?
   A. European Commission
   B. United Nations
   C. International Federation of Accountants
   D. Financial Accounting Standards Board
### Answers to quick revision questions

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1. **B** The IASB is not concerned with the currency in which financial statements are prepared.

2. **B** IFRSs to be used for consolidated financial statements.

3. **B** The IASB has no powers of enforcement.

4. **C** The IFRS Interpretation Committee interprets the application of IFRS and provides guidance on topics not specifically covered by an IFRS.

5. **D** GAAP is all the rules and regulations a company must follow so can include national as well as international standards.

6. **C** A, B and D are all perceived as disadvantages of the regulation of company accounts: more disclosure is required; the extra work involved in adhering to regulations is costly and competitors have access to more information which they may use to their advantage. Regulation does, however, result in higher quality, more comparable, relevant and reliable information.

7. **C** International Accounting Standards were issued by the IASB’s predecessor, the IASC.

8. **D** The IASB is focused on a program of harmonisation with the US standard-setter, FASB.
Answer to chapter question

1 Other examples of areas where the judgment of different people may vary are as follows:

(a) Valuation of buildings in times of rising property prices.
(b) Research and development: is it right to treat this only as an expense? In a sense it is an investment to generate future revenue.
(c) Accounting for inflation.
(d) Brands such as 'Coca Cola' or 'Hoover'. Are they assets in the same way that a fork lift truck is an asset?

Working from the same data, different groups of people produce very different financial statements. If the exercise of judgment is completely unrestrained, there will be no comparability between the accounts of different organisations. This will be all the more significant in cases where deliberate manipulation occurs, in order to present accounts in the most favourable light.

2 Methods of ‘creative accounting’ include:

(a) ‘Off balance sheet financing’: an entity enters into a financing transaction which is structured so that it can avoid having to recognise all its assets and liabilities in the statement of financial position. For example, a company might sell an asset but enter into an agreement to repurchase it after a set period of time. The substance of the transaction is that the company has a loan (a liability) secured on the asset that has been ‘sold’ but legally, the company has made a sale and so recognises cash and income. The company’s financial performance and particularly its financial position appear to be much stronger than they are. Transactions such as these enable a company to ‘hide’ material borrowings from shareholders and other lenders.

(b) ‘Window dressing’: at the year-end an entity enters into transactions whose sole purpose is to improve the appearance of the financial statements. For example, a company might make a fictitious ‘sale’, which would be reversed by means of a credit note early in the new reporting period. Revenue and profit would appear to be higher than they really were.

(c) ‘Profit smoothing’: in a profitable year an entity deliberately recognises a liability for future expenditure to which it is not committed (for example, for a ‘restructuring’ or for future losses). This ‘provision’ is then available to be released to the income statement to increase profits in a poor year (the provision is sometimes called the ‘big bath’).

(d) ‘Aggressive earnings management’: recognising sales revenue before it has been earned (before the entity has actually delivered the goods or performed the services).

Most of the accounting scandals of the past twenty years have involved one or more of these. For example, the management of Enron used a sophisticated form of off balance sheet financing to mislead the users of its financial statements.
Chapter 3
The conceptual framework of accounting

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**Topic list**

1. Conceptual framework and GAAP
2. The IASB’s Conceptual Framework
3. The objective of general purpose financial reporting
4. The use of judgment in accounting decisions
5. Future developments
This chapter focuses on the IASB’s Conceptual Framework for Financial Reporting which represents the theoretical framework on which all IFRS are based.

A conceptual framework for financial reporting can be defined as an attempt to codify existing generally accepted accounting principles (GAAP) in order to reappraise current accounting standards and to produce new standards.

This chapter looks at the focus of the Conceptual Framework and its uses in dealing with accounting situations which are not covered by accounting standards.
If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

1. What is a conceptual framework? (Section 1.1)
2. What are the problems associated with not having a conceptual framework? (Section 1.2)
3. Which of the following are objectives of the IASB's Conceptual Framework? (Section 2.2)
   - I to assist in the development of new IFRS
   - II to assist national standard-setters in setting national standards
   - III to promote consistency between IFRS
   - IV to assist auditors in forming their opinion
   A I, II, III and IV
   B I and III only
   C I, II and III only
   D II and IV only
4. What is the objective of general purpose financial reporting according to the IASB's Conceptual Framework? (Section 3)
5. According to the Conceptual Framework, why should financial information be prepared on the accruals basis? (Section 3.1)
1 Conceptual framework and GAAP

Section overview

- A conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.
- There are advantages and disadvantages to having a conceptual framework.

1.1 The search for a conceptual framework

As we are studying accounting concepts and principles in this Study Manual, a good starting point is to consider the conceptual framework within which accounting operates. A conceptual framework, in the field we are concerned with, is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore, a conceptual framework will form the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user. Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

1.2 The need for a conceptual framework

Definition

A conceptual framework is a coherent system of interrelated objectives and fundamental concepts that prescribes the nature, function and limits of financial accounting and reporting. (FASB)

A conceptual framework is a coherent system of concepts that flow from an objective. The objective of financial reporting is the foundation of the framework. The other concepts provide guidance on identifying the boundaries of financial reporting, selecting the transactions, other events and circumstances to be represented; how they should be recognised and measured (or disclosed); and how they should be summarised and communicated in financial reports. (IASB: Exposure Draft of an Improved Conceptual Framework for Financial Reporting (2008))

A conceptual framework is an important part of the financial reporting system as it underpins the development of accounting standards and sets out the basis of recognition of items in the financial statements such as assets, liabilities, income and expenses. It provides the basis for the development of new accounting standards and the evaluation of those already in existence.

The danger of not having a conceptual framework is demonstrated in the way some countries' standards have developed over recent years; standards tend to be produced in a haphazard manner. Where an agreed framework exists, the standard-setting body acts as an architect or designer, building accounting rules on the foundation of sound, agreed basic principles.

The lack of a conceptual framework also means that fundamental principles are tackled more than once in different standards, thereby producing contradictions and inconsistencies in basic concepts, such as those of prudence and matching. This leads to ambiguity and it affects the true and fair concept of financial reporting.

Another problem with the lack of a conceptual framework has become apparent in the US. The large number of highly detailed standards produced by the Financial Accounting Standards Board (FASB) has created a financial reporting environment governed by specific rules rather than general principles. This would be avoided if a cohesive set of principles were in place.

A conceptual framework can also bolster standard setters against political pressure from various 'lobby groups' and interested parties. Such pressure would only prevail if it was acceptable under the conceptual framework.
1.3 Advantages and disadvantages of a conceptual framework

Advantages

(a) The situation is avoided whereby standards are developed on a piecemeal basis, where a particular accounting problem is recognised as having emerged, and resources are then channelled into standardising accounting practice in that area, without regard to whether that particular issue is necessarily the most important issue remaining at that time without standardisation. The existence of a conceptual framework should result in standards that are more logical and which are consistent with each other.

(b) The situation is also avoided where there are significant ‘gaps’ and certain topics are never addressed. For example, before the development of the IASB’s and the US FASB’s conceptual frameworks there were no formal definitions of terms such as ‘asset’, ‘liability’ or ‘equity’.

(c) As stated above, the development of certain standards (particularly national standards) have been subject to considerable political interference from interested parties. Where there is a conflict of interest between user groups on which policies to choose, policies deriving from a conceptual framework will be less open to criticism that the standard-setter acceded to external pressure.

(d) The existence of a framework of principles means that it is much harder for preparers to avoid complying with reporting requirements. Rules can be avoided, but preparers must apply the ‘spirit’ and reasoning behind standards based on principles.

(e) Standard setters may become more accountable to the users of financial statements, because the reasoning behind specific standards should be clear. It should also be clear to users when standard setters have departed from the principles set out in the framework.

(f) The process of developing standards should be easier and less costly because the basic principles that underpin them have already been debated and established.

(g) Business is becoming increasingly complex. Accounting standards cannot cover all eventualities and in practice the development of standards has lagged behind the growth in particular types of complex transaction (for example in ‘off balance sheet’ finance). A conceptual framework provides principles that can be applied where there is no relevant accounting standard or other guidance.

(h) The existence of a conceptual framework contributes to the general credibility of financial reporting and increases public confidence in financial statements.

Disadvantages

(a) Financial statements are intended for a variety of users, and it is not certain that a single conceptual framework can be devised which will suit all users.

(b) Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a different purpose (and with different concepts as a basis).

(c) It is not clear that a conceptual framework makes the task of preparing and then implementing standards any easier than without a framework.

(d) In practice, conceptual frameworks can lead to accounting standards which are very theoretical and academic. They may increase the complexity of financial information and lead to solutions that are conceptually pure but are difficult to understand and apply for many preparers and users.

(e) Conceptual frameworks tend to focus on the usefulness of financial information in making ‘hold or sell’ decisions about an investment. However, many users of financial statements are also interested in information that will help them assess the stewardship of management.

(f) In addition, accounting principles focus only on economic phenomena: transactions that can be expressed in money terms. Many believe that other aspects of an entity’s operations, such as its effect on the natural environment or on the wider community, should be at least equally important in assessing its performance and making investment decisions.

Before we look at the IASB’s attempt to produce a conceptual framework, we need to consider another element of importance to this debate: Generally Accepted Accounting Principles or GAAP.
1.4 Generally Accepted Accounting Principles (GAAP)

We defined **GAAP** in the previous chapter as all of the rules, from whatever source, which govern accounting.

There are different views of GAAP in different countries. The UK position can be explained in the following extracts from UK GAAP (Davies, Paterson & Wilson, Ernst & Young, 5th edition).

‘Our view is that GAAP is a dynamic concept which requires constant review, adaptation and reaction to changing circumstances. We believe that use of the term ‘principle’ gives GAAP an unjustified and inappropriate degree of permanence. GAAP changes in response to changing business and economic needs and developments. As circumstances alter, accounting practices are modified or developed accordingly….. We believe that GAAP goes far beyond mere rules and principles, and encompasses contemporary permissible accounting practice.

‘It is often argued that the term ‘generally accepted’ implies that there must exist a high degree of practical application of a particular accounting practice. However, this interpretation raises certain practical difficulties. For example, what about new areas of accounting which have not, as yet, been generally applied? What about different accounting treatments for similar items – are they all generally accepted?

‘It is our view that ‘generally accepted’ does not mean ‘generally adopted or used’. We believe that, in the UK context, GAAP refers to accounting practices which are regarded as permissible by the accounting profession. The extent to which a particular practice has been adopted is, in our opinion, not the overriding consideration. Any accounting practice which is legitimate in the circumstances under which it has been applied should be regarded as GAAP. The decision as to whether or not a particular practice is permissible or legitimate would depend on one or more of the following factors:

- Is the practice addressed either in the accounting standards, statute or other official pronouncements?
- If the practice is not addressed in UK accounting standards, is it dealt with in International Accounting Standards, or the standards of other countries such as the US?
- Is the practice consistent with the needs of users and the objectives of financial reporting?
- Does the practice have authoritative support in the accounting literature?
- Is the practice being applied by other companies in similar situations?
- Is the practice consistent with the fundamental concept of ‘true and fair’?

This view is not held in all countries, however. In the US particularly, the equivalent of a ‘true and fair view’ is ‘fair presentation in accordance with GAAP’. Generally Accepted Accounting Principles are defined as those principles which have ‘substantial authoritative support’. Therefore, accounts prepared in accordance with accounting principles for which there is not substantial authoritative support are presumed to be misleading or inaccurate.

The effect here is that ‘new’ or ‘different’ accounting principles are not acceptable unless they have been adopted by the mainstream accounting profession, usually the standard-setting bodies and / or professional accountancy bodies. This is much more rigid than the UK view expressed above.

In contrast, however, in Australia there does not seem to be any strong body of opinion on GAAP. GAAP is only used by Australian companies if they need to prepare financial statements to US standards in order to raise funds from, or obtain a listing, in the US. Otherwise, Australian companies are happy to implement IFRS and the pronouncements of the IASB and AASB.

1.5 GAAP and a conceptual framework

A **conceptual framework** for financial reporting can be defined as an attempt to codify existing GAAP in order to reappraise current accounting standards and to produce new standards. Therefore, there is more to a conceptual framework than just accounting standards as the other components of GAAP are also important as discussed above.
2 The IASB's Conceptual Framework

Section overview

- The Conceptual Framework provides the theoretical framework for the development of IFRS.

The IASB's Conceptual Framework for Financial Reporting is, in effect, the theoretical framework upon which all IFRS are based and therefore determines how financial statements are prepared and the information they contain.

The Conceptual Framework consists of several sections or chapters, following on after a preface and introduction. Some of these chapters have been adopted from the previous 'Framework for the Preparation and Presentation of Financial Statements' and will be replaced in due course. The chapters are as follows:

- The objective of general purpose financial reporting (see below)
- The reporting entity (not yet issued)
- Qualitative characteristics of useful financial information (see chapter 4)
- The Framework 1989
- Underlying assumption (see below)
- The elements of financial statements (see chapter 5)
- Recognition of the elements of financial statements (see chapter 5)
- Measurement of the elements of financial statements (see chapter 5)
- Concepts of capital and capital maintenance (see chapters 5, 6)

We will look briefly at the preface and introduction to the Conceptual Framework in this chapter, and the remaining Conceptual Framework chapters are studied later in this Study Manual.

2.1 Introduction

The introduction to the Conceptual Framework points out the fundamental reason why financial statements are produced worldwide, i.e. to satisfy the requirements of external users, but that practice varies due to the individual pressures in each country. These pressures may be social, political, economic or legal, but they result in variations in practice from country to country, including the form of statements, the definition of their component parts (assets, liabilities, equity, income, expenses), the criteria for recognition of items and both the scope and disclosure of financial statements.

It is these differences which the IASB wishes to narrow by harmonising all aspects of financial statements, including the regulations governing their accounting standards and their preparation and presentation.

The introduction emphasises the way financial statements are used to make economic decisions and therefore financial statements should be prepared to this end.

Any additional requirements imposed by national governments for their own purposes should not affect financial statements produced for the benefit of other users.

The Conceptual Framework recognises that financial statements can be prepared using a variety of models. Although the most common is based on historical cost and a nominal unit of currency, e.g. AUS dollars, the Conceptual Framework can be applied to financial statements prepared under a range of models.

Question 1: Economic decisions

Financial statements provide information that helps users to make economic decisions. What are the main types of economic decision for which financial statements are likely to be used?

(The answer is at the end of the chapter)
2.2 Purpose and status

The introduction gives a list of the purposes of the Conceptual Framework.

(a) Assist the members of the IASB in the development of future IFRS and in its review of existing IFRS.
(b) Assist the members of the IASB in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRS.
(c) Assist national standard-setting bodies in developing national standards.
(d) Assist preparers of financial statements in applying IFRS and in dealing with topics that have yet to form the subject of an IFRS.
(e) Assist auditors in forming an opinion as to whether financial statements comply with IFRS.
(f) Assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRS.
(g) Provide those who are interested in the work of IASB with information about its approach to the formulation of IFRS.

The Conceptual Framework is not an International Financial Reporting Standard and so does not overrule any individual IFRS. In the rare cases of conflict between an IFRS and the Conceptual Framework, the IFRS will prevail. These cases will diminish over time as the Conceptual Framework will be used as a guide in the production of future IFRS. The Conceptual Framework itself will be revised occasionally depending on the experience of the IASB in using it.

2.3 Scope

The Conceptual Framework deals with:

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

The Conceptual Framework is concerned with general purpose financial reporting. The term is not defined or discussed in the Conceptual Framework, but generally means a normal set of annual financial statements or published annual report available to users outside the reporting entity.

The Conceptual Framework does not currently include a definition of a reporting entity. The IASB is currently developing an additional chapter that will define and explain the concept of a reporting entity.

In Australia, a reporting entity is defined as 'an entity in respect of which it is reasonable to expect the existence of users who rely on the entity’s general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries'.

3 The objective of general purpose financial reporting

Section overview

- The Conceptual Framework states that:

  'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.'
These decisions involve buying, selling or holding equity shares and debt instruments (such as loan stock or debentures) and providing or settling loans and other forms of credit.

The Conceptual Framework explains that investors and lenders must normally rely on general purpose financial reports for most of the financial information that they need. Therefore they are the primary users to which general purpose financial reports are directed.

The focus is on capital providers as the primary users of financial statements. Traditionally, in many countries there has been a second objective of financial statements: to show the results of the stewardship of management (the accountability of management for the resources entrusted to it). The revised Conceptual Framework does not explicitly state this or use the term ‘stewardship’, although it does explain that investors and other capital providers need information about how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s resources, for example, to protect the entity’s resources from unfavourable effects of economic factors (such as price changes) and ensuring that the entity complies with applicable laws and regulations.

General purpose financial reports cannot provide all the information that investors, lenders and other creditors need. They may also need to consider relevant information from other sources, for example, general economic conditions and expectations, political events and information about the industry in which the company operates.

The Conceptual Framework explains that other users, such as regulators and members of the public may also find general purpose financial reports useful. However, financial reports are not primarily prepared for these groups of users.

### Question 2: Users of financial information

In Chapter 1 we discussed the users of accounting information. List the seven groups of users and describe the information needs of each group.

(The answer is at the end of the chapter)

#### 3.1 Economic resources, claims and changes in resources and claims

Financial reports provide information about the financial position of an entity:

(a) its economic resources; and
(b) the claims against it.

They also provide information about changes in an entity’s economic resources and claims.

Information about the entity’s economic resources and the claims against it helps users to assess the entity’s liquidity and solvency, its needs for additional finance and how successful it is likely to be in obtaining it.

### Definitions

**Liquidity.** The availability of sufficient funds to meet short-term financial commitments as they fall due.

**Solvency.** The availability of cash over the longer term to meet financial commitments as they fall due.

**Changes** in an entity’s economic resources and claims result from its financial performance and also from other transactions and events such as the issue of shares or an increase in debt (borrowings).

Information about a reporting entity’s financial performance helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiently and effectively management has used the resources of the entity and is helpful in predicting future returns.

Information about an entity’s financial performance helps users to assess the entity’s past and future ability to generate net cash inflows from its operations.

Financial information should be prepared using accrual accounting. Information about an entity’s economic resources and claims and changes in these during a period is more useful in assessing an entity’s past and future performance than information based solely on cash receipts and payments during that period.
Definitions

Accrual accounting. depicts the effects of transactions and other events and circumstances on a reporting entity’s economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

(Conceptual Framework)

Information about a reporting entity’s cash flows during a period also helps users assess the entity’s ability to generate future net cash inflows and provides information about factors that may affect its liquidity or solvency. It also gives users a better understanding of the entity’s operations and of its financing and investing activities.

4 The use of judgment in accounting decisions

Financial statements are prepared on the basis of a number of fundamental accounting assumptions and conventions. Many figures in financial statements are derived from the application of judgment in applying fundamental accounting assumptions and conventions. This can lead to subjectivity.

4.1 Accounting standards

In an attempt to deal with some of the subjectivity, and to achieve comparability between different organisations, accounting standards were developed. These standards are developed at both a national level (in most countries) and an international level. In this Study Manual we are concerned with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).

The role of accounting standards is discussed in more detail in Chapter 4.

4.2 Accounting for situations where accounting standards do not exist

When there is no specific legal regulation or accounting standard which covers an item in the accounts, the accountant must make a decision on how this item will be dealt with in the financial statements. It may be possible to account for the item following the accounting treatment of a similar item. The accountant may need to make a judgment on the treatment of the item and account for it so that the financial statements show a true and fair view or a fair presentation of the financial performance and financial position of the entity.

4.3 Use of conceptual framework

A conceptual framework, such as the IASB Conceptual Framework can be beneficial in situations where transactions are not covered by an accounting standard. The IASB’s Conceptual Framework includes definitions of the elements of financial statements, i.e. assets, liabilities, equity, income and expenses, and their recognition criteria. The Conceptual Framework also includes the qualitative characteristics of financial information – these are the characteristics that financial information should contain if it is to be useful to users. Therefore, the accountant will have sufficient information contained within the Conceptual Framework to be able to exercise judgment and decide how to deal with the transaction in a way that properly represents the underlying transaction.
For example, the accountant can refer to the definitions of assets and liabilities and consider whether the transaction gives rise to new assets or new liabilities.

In this situation, the Conceptual Framework serves as a useful basis for accountants to refer to when dealing with transactions not covered by an accounting standard. As the same recognition principles are included in accounting standards, the outcome should be a consistent method of accounting regardless of the detail in standards.

5 Future developments

Section overview

- The IASB’s Conceptual Framework is in the process of being developed and will eventually replace the old ‘Framework’ in its entirety.

5.1 Revised Framework

The IASB has been undertaking a process of convergence of IFRS with US GAAP over the past few years (see Chapter 2).

As part of this convergence process the IASB and the US FASB are carrying out a joint project to develop a new conceptual framework. The IASB states that the aim of the project to revise the Framework is to “create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged.”

The project has taken place in a number of different phases, focusing on different elements of the Framework in each phase. The phases are as follows:

A Objectives and qualitative characteristics
B Definitions of elements, recognition and derecognition
C Measurement
D Reporting entity concept
E Presentation and Disclosure
F Purpose and status of the Framework
G Application of the framework to non-for profit entities
H Remaining issues, if any.

5.2 Progress to date

The current IASB Conceptual Framework for Financial Reporting consists of the original IASB Framework for the Preparation and Presentation of Financial Statements (originally issued in 1989) with some chapters replaced by those parts of the new Conceptual Framework that have been finalised.

To date the IASB has finalised Phase A (Objectives and Qualitative Characteristics) and has issued an Exposure Draft of Phase D (The Reporting Entity).
Key chapter points

• A conceptual framework is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting.
• There are advantages and disadvantages to having a conceptual framework.
• The IASBs Conceptual Framework for Financial Reporting provides the theoretical framework for the development of IFRS.
• The Conceptual Framework states that:
  'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.'
• Many figures in financial statements are derived from the application of judgment in applying fundamental accounting assumptions and conventions. This can lead to subjectivity.
### Quick revision questions

1. A conceptual framework is:
   - A a theoretical expression of accounting standards
   - B a list of key terms used by the IASB
   - C a statement of theoretical principles which form the frame of reference for financial reporting
   - D the proforma financial statements

2. Which of the following is an advantage of a conceptual framework?
   - A there are a variety of users, so not all will be satisfied with the content of the framework
   - B there are a variety of accounting situations which mean flexibility in the accounting approach is needed
   - C the framework does not simplify the preparation and implementation of standards
   - D a framework encourages standardised accounting practice

3. What is the name of the IASB's conceptual framework?
   - A The Conceptual Framework for the disclosure of financial statements
   - B The Conceptual Framework for the presentation of financial statements to users
   - C The Conceptual Framework for Financial Reporting
   - D Statement of principles for financial reporting

4. What is the fundamental reason that financial statements are produced according to the preface of the IASB's Conceptual Framework?
   - A to provide information to tax authorities
   - B to report on a company’s performance to its national government
   - C to satisfy the requirements of external users
   - D to provide information for internal management

5. Which of the following are uses of financial statements prepared by a company?
   - I Decisions to buy, hold or sell equity investments
   - II Assessment of the security of amounts lent to the entity
   - III Assessment of management stewardship and accountability
   - IV Inclusion in national income statistics
   - A I and III only
   - B I and IV only
   - C II and III only
   - D I, II, III and IV

6. According to the Conceptual Framework, who has responsibility for preparing an entity’s financial statements?
   - A management
   - B accountants
   - C shareholders
   - D auditors

7. According to the Conceptual Framework, who are the most important users of general purpose financial reports?
   - A investors and employees
   - B investors and the government
   - C investors and lenders
   - D lenders and management
8. If an accountant comes across a transaction that is not covered by an accounting standard, where should they look for guidance on accounting for that item?

A. company law  
B. US GAAP  
C. conceptual framework  
D. UK GAAP
Answers to quick revision questions

1 C A conceptual framework is sometimes referred to as a ‘guiding light’ which underpins accounting standards.

2 D The framework provides the principles which underpin all IFRS; in addition its principles are applied where no standard exists. Therefore all transactions are effectively accounted for in line with the framework, so resulting in standardised accounting practice.


4 C All are valid reasons that financial statements are produced, but the key reason is C.

5 D They are all uses of the financial statements.

6 A The management have the ultimate responsibility for the preparation of financial statements although they may delegate this to accountants within their organisation.

7 C Existing and potential investors, lenders and other creditors (providers of capital).

8 C The underlying principles contained within the conceptual framework should be applied.
Answers to chapter questions

1. The types of economic decisions for which financial statements are likely to be used include the following:
   - Decisions to buy, hold or sell equity investments
   - Assessment of management stewardship and accountability
   - Assessment of the entity’s ability to pay employees
   - Assessment of the security of amounts lent to the entity
   - Determination of taxation policies
   - Determination of distributable profits and dividends
   - Inclusion in national income statistics
   - Regulations of the activities of entities

2. (a) **Investors** are the providers of risk capital:
   - (i) Information is required to help make a decision about buying or selling shares, taking up a rights issue and voting.
   - (ii) Investors must have information about the level of dividend, past, present and future and any changes in share price.
   - (iii) Investors will also need to know whether the management has been running the company efficiently.
   - (iv) As well as the position indicated by the statement of comprehensive income, statement of financial position and earnings per share (EPS), investors will want to know about the liquidity position of the company, the company’s future prospects, and how the company’s shares compare with those of its competitors.

   (b) **Employees** need information about the security of employment and future prospects for jobs in the company, and to help with collective pay bargaining.

   (c) **Lenders** need information to help them decide whether to lend to a company. They will also need to check that the value of any security remains adequate, that the interest repayments are secure, that the cash is available for redemption at the appropriate time and that any financial restrictions (such as maximum debt/equity ratios) have not been breached.

   (d) **Suppliers and other creditors** need to know whether the company will be a good customer and pay its debts.

   (e) **Customers** need to know whether the company will be able to continue producing and supplying goods.

   (f) **Government’s** interest in a company may be that of a creditor or customer, as well as being specifically concerned with compliance with tax and company law, ability to pay tax and the general contribution of the company to the economy.

   (g) The **public** at large would wish to have information for all the reasons mentioned above, but it could be suggested that it would be impossible to provide general purpose accounting information which was specifically designed for the needs of the public.
Chapter 4

Accounting standards and concepts

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**Topic list**

1. The role of accounting standards
2. Accounting standards and choice
3. Accounting policies
4. Qualitative characteristics of financial information
5. Setting of International Financial Reporting Standards
6. International harmonisation
This chapter is concerned with the role and purpose of accounting standards in the regulation of financial reporting. We will look at this in the context of accounting policies and achieving the aim of preparing useful financial information. We will then examine the standard setting process of the IASB.

We will also review some of the key accounting concepts that have to be considered when preparing financial statements and finally, discuss the process of harmonisation of accounting standards on a global basis.
If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

1. What are accounting policies? (Section 3)
2. What criteria should be satisfied when selecting appropriate accounting policies? (Section 3.1)
   - A. accruals, and relevance
   - B. accruals and reliability
   - C. consistency and relevance
   - D. relevance and reliability
3. What makes financial information relevant? (Section 3.1.1)
4. What is the underlying assumption in preparing financial statements? (Section 3.2.1)
5. Explain the concept of ‘substance over form’ and provide an example of its application. (Section 3.3)
6. Identify three barriers to the global harmonisation of accounting standards. (Section 6.2)
7. Identify three advantages of the global harmonisation of accounting standards. (Section 6.3)
1 The role of accounting standards

1.1 Introduction

This chapter will examine the purpose of accounting standards as the means of setting out the accounting rules to be followed. First, we will discuss the two different methods of setting accounting rules, the principles-based and rules-based approaches and then look at the role of accounting standards in more detail.

1.2 Principles-based versus rules-based systems

Section overview

- A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.

Under international accounting, the IASB’s Conceptual Framework for Financial Reporting is intended to provide the underlying principles within which standards can be developed. One of the main purposes of a conceptual framework is to ensure that standards are not produced which are in conflict with each other. In addition, any departure from a standard can be judged on the basis of whether or not it is in keeping with the principles set out in the Conceptual Framework. A principles-based system of accounting is a system which is based on a conceptual framework.

The opposite of a principles based system is a rules-based system. There is a large mass of detailed regulation designed to cover every eventuality.

In practice, most standard setting bodies, including the IASB, have developed or adopted standards that are a mixture of principles and rules. IFRS can currently be viewed as a ‘hybrid’ system: there is a conceptual framework and many standards are principles-based, but some (mainly those influenced by US GAAP) are rules-based.

1.3 The differences between a principles-based system and a rules-based system

A rules-based system requires preparers to understand and apply detailed rules to report specific transactions.

A principles-based system requires preparers to use judgment in order to develop accounting policies to report specific types of transactions and events.

Consider accounting for tangible non-current assets. An extreme rules-based approach would set out precise requirements for each type of asset, for example:

‘Plant and equipment should be depreciated on the straight line basis over a period not exceeding four years.’

A principles-based approach would contain more general requirements, for example:

‘The depreciable amount of an asset shall be allocated on a systematic basis over its useful life….The depreciation method used shall reflect the pattern in which the asset’s future economic benefits are expected to be consumed by the entity.’ (IAS 16 Property, plant and equipment.)

Rules-based accounting standards often need to contain complex definitions and scope exceptions. For example, if plant and equipment must be depreciated over four years, while other classes of asset are depreciable over a longer period, the standard must define what is meant by plant and equipment. Standards often contain further material that explains and interprets the rules and this in turn may be supplemented by guidance and regulations relating to particular industries or types of transaction. As a result, accounting standards and guidance are voluminous.
A purely rules-based system has the following advantages:

- in theory, it results in financial statements being **comparable** between entities (or between entities in the same industry)
- it may **reduce the volume of explanation necessary in financial statements** (as in theory there is only one allowed accounting treatment for each type of transaction or event)
- it is suitable for **large, complex economies** (such as the US)
- it provides the ‘answers’ in almost all situations; preparers **do not have to make judgments** and risk the consequences (eg, litigation or reputational damage if a user makes a wrong decision based on information in the financial statements).

Principles-based accounting standards are likely to be less lengthy and complex than rules-based standards, with fewer definitions and scope exceptions.

There may be an explicit requirement that the financial statements show a ‘true and fair view’ of the entity’s financial performance and financial position and that this requirement should override all others. An entity may depart from a requirement if management is convinced that this is necessary (normally in exceptional circumstances).

Standards normally require **very full disclosure** of information about the nature of transactions or events and the accounting policies adopted. This is seen as necessary in order for users to understand the information that is being presented in the financial statements and to make meaningful comparisons between different entities.

In practice, principles based standards often need to be accompanied or supported by **explanatory material, illustrative examples, and interpretations**. Both the IASB and the UK Accounting Standards Board have a separate operating body that issues interpretations of standards where serious difficulties arise, while the Australian Accounting Standards Board appoint Interpretation Advisory Panels on an ad hoc basis.

A purely or mainly **principles-based system** has the following advantages:

- in theory, it is more likely than a rigid-rules based system to result in financial statements that show a **true and fair view/give a fair presentation**
- it encourages the use of **professional judgment**
- it is less open to ‘creative accounting’ abuses as principles are harder to evade than rules
- arguably it is **more flexible** than a system of rules and can therefore cope better with a rapidly changing business and economic environment

See also the advantages of a conceptual framework in Chapter 3; many of these also apply here.

**Question 1: Definition of Going Concern**

Below are some extracts from AASB 1008, an Australian accounting standard that has now been superseded by AASB 117 which is converged with the international standard IAS 17 Leases. The way in which a lease is classified can have a significant impact on the financial statements.

*The classification of a lease depends upon its economic substance. Where substantially all of the risks and benefits incident to ownership of the leased asset effectively remain with the lessor, the lease is an operating lease. Where substantially all of these risks and benefits effectively pass to the lessee, the lease is a finance lease.*

*The effective passing of substantially all of the risks and benefits incident to ownership from a lessor to a lessee is normally presumed where both of the following criteria are satisfied:*

(a) the lease is a non-cancellable lease

(b) either one or both of the following tests is met:

(i) the lease term is for 75 per cent or more of the remaining economic life of the leased asset

(ii) the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 per cent of the fair value of the leased asset at the inception of the lease.
(a) What type of standard is this, rules-based or principles-based?

(b) Explain why the requirements above might have reduced the usefulness of the information in the financial statements. (You are not required to discuss accounting for leases in your answer.)

(The answer is at the end of the chapter)

1.4 The purpose of accounting standards

Definition

**Accounting standards.** Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in the financial statements.

Accounting standards form part of the Generally Accepted Accounting Principles (GAAP) that sets out the accounting rules that companies must abide by. They are structured to provide detailed guidance on accounting for a particular item. For example, there are a number of accounting standards that deal with the accounting treatment of items recognised in the financial statements such as non-current assets, provisions and liabilities.

Accounting standards are of key importance in the regulation process as they provide the detailed rules on dealing with transactions and disclosures in the financial statements. Without this detailed guidance, companies would be free to account for transactions as they wished, which would firstly reduce the comparability of financial statements and secondly, could lead to misleading accounts if companies report transactions in a more favourable light. Neither of these options would be beneficial to users of the financial statements.

In many countries, including Australia, accounting standards have the force of law. Some or all limited companies are required to comply with them in preparing financial statements. Listing authorities also require compliance with standards as a condition of obtaining a stock exchange listing. In some countries, including Australia and the UK, some not-for-profit entities and governmental organisations may also be required to comply with accounting standards.

Even where compliance is not an actual requirement (for example, for a small or unincorporated entity) the requirements of accounting standards are normally taken to represent ‘best practice’.

1.4.1 Accounting standards and the conceptual framework

We have already seen in Chapter 3 that a conceptual framework exists to provide a basis for the preparation of financial statements. Therefore, accounting standards will also be prepared on the same basis. For example, any accounting standard dealing with the recognition of assets will include the definition of an asset from the conceptual framework as well as the relevant recognition criteria. This way, the accounting standards are consistent with the principles of the conceptual framework. This also means that in situations where there is no accounting standard covering a particular transaction, the Conceptual Framework can be used to assist in dealing with the accounting.

1.4.2 Accounting standards and a fair presentation

The objective of financial statements is to provide information about the financial position and performance of an entity. Financial information should show a fair presentation or true and fair view of the activities of an entity.

Like ‘true and fair view’, ‘present fairly’ is not defined in the Conceptual Framework or in any IFRS. However, IAS 1 *Presentation of financial statements* explains that:

- Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Conceptual Framework.

- The application of IFRS, with additional disclosure where necessary, is presumed to result in financial statements that achieve a fair presentation.

We will examine the meaning of faithful representation later in this chapter.
Although compliance with accounting standards is presumed to result in fair presentation, fair presentation involves more than mere compliance. Preparers should apply the ‘spirit’ (or general intention) behind an accounting standard as well as the strict ‘letter’. The requirement to ‘present fairly’ also applies to transactions which are not covered by any specific accounting standard.

Fair presentation requires an entity:

- to select and apply appropriate accounting policies
- to present information in a manner that results in relevant, reliable, comparable and understandable information
- to provide additional disclosures where these are necessary to enable users to understand the impact of transactions and events on an entity’s financial performance and position

IAS 1 states that disclosure (explanatory material or notes) does not rectify inappropriate accounting policies.

1.4.3 True and fair override

The requirement to give a true and fair view may in special circumstances require a departure from accounting standards. There may be very rare circumstances when management decides that compliance with a requirement of an IFRS would be misleading. Departure from the IFRS is therefore required to achieve a fair presentation. There are a number of disclosures that must be made in these circumstances so that the users of the financial statements understand the reason and impact of the departure from the accounting standard.

In Chapter 2 Section 2.8, however, we discussed the fact that this is not acceptable in all jurisdictions, a notable example being Australia.

1.5 Scope and application of IFRS

1.5.1 Scope

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRS are not intended to be applied to immaterial items, nor are they generally retrospective. Each individual IFRS lays out its scope at the beginning of the standard.

1.5.2 Application

Within each individual country local regulations govern, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and / or professional accountancy bodies in the country concerned.

2 Accounting standards and choice

Section overview

- There are arguments for and against having accounting standards at all.

It is sometimes argued that having accounting standards at all actually reduces the quality of financial reporting, and that individual companies should be given more choice over how they report transactions. There are arguments on both sides.

2.1 Advantages of accounting standards

Standards have the following advantages:

- They reduce or eliminate confusing variations in the methods used to prepare accounts.
- They provide a focal point for debate and discussions about accounting practice.
- They oblige companies to disclose the accounting policies used in the preparation of accounts.
- They are a less rigid alternative to enforcing conformity by means of legislation.
• They have obliged companies to disclose more accounting information than they would otherwise have done if standards did not exist.
• The development of IFRS involves a full consultative process in which user groups are directly involved.

2.2 Disadvantages of accounting standards
The disadvantages of accounting standards are as follows:
• A set of rules which give backing to one method of preparing accounts might be inappropriate in some circumstances.
• Standards may be subject to lobbying or government pressure.
• Earlier standards were not based on a conceptual framework of accounting but the IASB is committed to rectifying this.
• There may be a trend towards rigidity, and away from flexibility in applying the rules. Some commentators feel that professional judgment should be used on technical matters.

Case study: Economic consequences
Another disadvantage of accounting standards is that they may have unforeseen economic consequences for the entities who have to apply them and for others.

The UK standard FRS 17 Accounting for retirement benefits changed the financial reporting treatment of some types of pension scheme (defined benefit schemes). This had the effect of significantly increasing the non-current liabilities of the companies that operated those schemes. As a result, most companies which operated direct benefit schemes closed them to new entrants and replaced them with pension arrangements that were much less advantageous to their employees.

It has been argued that accounting standards should reflect economic reality (eg, companies that operate defined benefit schemes have a liability for the cost of providing pensions in future periods) and standard setters should not concern themselves with the possible consequences of requiring a particular accounting treatment. Recently, however, following the global economic crisis, a few commentators and politicians have begun to question this.

3 Accounting policies

Section overview
Accounting policies have two attributes:
• Relevance
• Reliability

Having considered accounting concepts and standards, we must now look at accounting policies. These are defined in IAS 8 Accounting policies, changes in accounting estimates and errors.

Definition
Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

You will see from this definition that companies have some choice in the matter of accounting policies. How to apply a particular accounting standard, where a choice exists, is a matter of accounting policy. How items are presented in the accounts, where alternative presentations are allowed, is a matter of accounting policy. Policies should be chosen to comply with IFRS, but with the overriding need for fair presentation.
The first note to a company's accounts is the disclosure of accounting policies. This will include the depreciation policy and other issues, such as valuation of inventory or revaluation of non-current assets.

Another term used is estimation techniques, sometimes called accounting estimates. These involve the use of judgment when applying accounting policies. For instance, the accounting policy may state that non-current assets are depreciated over their expected useful life. The decision regarding the length of useful life is a matter of estimation. The decision regarding method of depreciation is also a matter of estimation, rather than accounting policy.

There is the further matter of measurement bases. Is the value of the asset, upon which its depreciation is based, stated at original cost or revalued amount or current replacement cost? This is the measurement basis and will be stated in the accounting policy. The company must disclose in the notes to the accounts any change of accounting policy. Any change in measurement basis is regarded as a change of accounting policy and must be disclosed. Any change in estimation technique is not a change of accounting policy and does not need to be disclosed.

3.1 Objectives in selecting accounting policies

In selecting accounting policies, businesses should seek to satisfy two primary criteria: relevance and reliability. These criteria are characteristics of useful financial information.

The IASB's Conceptual Framework for Financial Reporting uses the terms relevance and faithful representation (which has a similar meaning to reliability). We will look at the characteristics of useful financial information in more detail later in this chapter.

3.1.1 Relevance

Appropriate accounting policies will result in the presentation of relevant financial information. Financial information is relevant if it is:

- Capable of influencing the economic decisions of users.
- Provided in time to influence those decisions.

Relevant information possesses either predictive or confirmatory value or both.

3.1.2 Reliability

Financial information is reliable if:

- It reflects the substance of transactions i.e. represents faithfully what has taken place.
- It is free from bias, or is neutral.
- It is free from material error.
- It is complete.
- Prudence has been applied where there is any uncertainty.

Question 2: Accounting policy

Decide whether or not these represent a change of accounting policy:

(a) The company has previously included certain overheads within cost of sales. It now proposes to show those overheads within administrative expenses.

(b) A company has previously depreciated vehicles using the reducing balance method at 40 per cent per year. It now proposes to depreciate vehicles using the straight-line method over five years.

(c) A company has previously measured inventory at weighted average cost. It now proposes to measure it on a FIFO basis.

(The answer is at the end of the chapter)
3.2 Accounting concepts

3.2.1 Going concern

Definition

An entity is normally viewed as a going concern. In other words, it will continue in business for the foreseeable future and management has neither the intention nor the need to materially scale down operations or liquidate the entity.

This concept assumes that, when preparing a normal set of accounts, the business will continue to operate in approximately the same manner for the foreseeable future (at least the next 12 months). In particular, the entity will not go into liquidation or scale down its operations in a material way.

The main significance of a business being a going concern is that the assets should not be valued at their ‘break-up’ value, that is the amount they would sell for if they were sold off piecemeal and the business was broken up, unless the assets satisfy the requirements of IFRS 5 Non-current assets held for sale and discontinued operations. Further liabilities are classified as current or non-current.

3.2.2 Example: Going concern

Emma acquires a T-shirt printing machine at a cost of $60 000. The asset has an estimated life of six years with a scrap value of nil at the end of six years, and it is normal to write off the cost of the asset to the income statement over this time. In this case a depreciation cost of $10 000 per year is charged.

Using the going concern assumption, it is presumed that the business will continue its operations and so the asset will produce economic benefits throughout its full six years in use. A depreciation charge of $10 000 is made each year, and the value of the asset in the statement of financial position is its cost less the accumulated depreciation charged to date. After one year, the carrying value of the asset is $(60 000 – 10 000) = $50 000, after two years it is $40 000, after three years $30 000 and so on, until it is written down to a value of zero after six years.

This asset has no other operational use outside the business and, in a forced sale, it would only sell for scrap. After one year of operation, its scrap value is $8 000.

The carrying value of the asset, applying the going concern assumption, is $50 000 after one year, but its immediate sell-off value only $8 000. It can be argued that the asset is over-valued at $50 000, that it should be written down to its break-up value ($8 000) and the balance of its cost should be treated as an expense. However, provided that the going concern assumption is valid, it is appropriate accounting practice to value the asset at its carrying value.

Question 3: Going concern

A retailer commences business on 1 January and buys inventory of 20 washing machines, each costing $100. During the year he sells 17 machines at $150 each. How should the remaining machines be valued at 31 December in the following circumstances?

(a) He is forced to close down his business at the end of the year and the remaining machines will realise only $60 each in a forced sale.

(b) He intends to continue his business into the next year.

(The answer is at the end of the chapter)
If the going concern assumption is not followed, that fact must be disclosed, together with the following information:

(a) The basis on which the financial statements have been prepared.
(b) The reasons why the entity is not considered to be a going concern.

3.2.3 Accruals basis of accounting

Definition

In the accruals basis of accounting, items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the Conceptual Framework. (IAS 1)

Entities should prepare their financial statements on the basis that transactions are recorded in them, not as the cash is paid or received, but as the revenues or expenses are earned or incurred in the accounting period to which they relate.

According to the accruals assumption, profit is computed as the surplus / (deficit) of revenue and expenses. In computing profit, revenue earned must be matched against the expenditure incurred in earning it. This is also known as the matching convention.

3.2.4 Example: Accruals

Emma prints 20 T-shirts in her first month of trading (May) at a cost of $5 each (purchased on credit terms). She then sells all of them for $10 each. Emma has therefore made a profit of $100, the surplus of revenue ($200) earned over the cost ($100) of acquiring them.

If, however, Emma only sells 18 T-shirts, it is incorrect to charge her income statement with the cost of 20 T-shirts, as she still has two T-shirts in inventory. If she sells them in June, she is likely to make a profit on the sale. Therefore, the profit is $90, the surplus of sales revenue ($180) over the purchase cost of 18 T-shirts ($90).

Her statement of financial position will look like this.

<table>
<thead>
<tr>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
</tr>
<tr>
<td>Inventory (at cost, i.e. 2 × $5)</td>
</tr>
<tr>
<td>Accounts receivable (18 × $10)</td>
</tr>
<tr>
<td><strong>190</strong></td>
</tr>
<tr>
<td>Capital and liabilities</td>
</tr>
<tr>
<td>Proprietor’s capital (profit for the period: 18 × $5)</td>
</tr>
<tr>
<td>Accounts payable (20 × $5)</td>
</tr>
<tr>
<td><strong>190</strong></td>
</tr>
</tbody>
</table>

However, if Emma had decided to give up selling T-shirts, then the going concern assumption no longer applies and the value of the two T-shirts in the statement of financial position is break-up valuation, not cost. Similarly, if the two unsold T-shirts are unlikely to be sold at more than their cost of $5 each (say, because of damage or a fall in demand) then they should be recorded on the statement of financial position at their net realisable value (i.e. the likely eventual sales price less any expenses incurred to make them saleable, i.e. say, $4 each) rather than cost. This shows the application of the prudence concept, which we will discuss shortly.

In this example, the concepts of going concern and accrual are linked. Since the business is assumed to be a going concern, it is possible to carry forward the cost of the unsold T-shirts as a charge against profits of the next period.

3.3 Substance over form

Faithful representation of a transaction is only possible if it is accounted for according to its substance and economic reality, not solely based on its legal form.
Definition

Substance over form. The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. (Conceptual Framework)

For instance, one party may sell an asset to another party and the sales documentation may record that legal ownership has been transferred. However, if agreements exist whereby the party selling the asset continues to enjoy the future economic benefits arising from the asset, then in substance no sale has taken place.

An example of substance over form is found in accounting for finance leases. A finance lease is one in which the risks and rewards of ownership are transferred to the lessee (the party who physically holds the asset). In a finance lease arrangement, the lessee never obtains legal title to the asset so does not own that asset. However, they have all the risks and rewards of ownership, such as the right to use the asset for most, if not all, of its useful life and they must bear the costs of ownership such as insurance and maintenance. For this reason, the asset is capitalised in the lessee’s accounts and treated as an owned asset, following the substance of the transaction. This accounting treatment will ensure that the financial statements show the true financial position of the entity, and does not hide assets and liabilities from the statement of financial position.

In accounting for the finance lease above, if the legal form was followed, the asset and the finance lease liability would not be recognised which would make the financial statements look better than they actually are. This has the effect of improving the gearing ratio, as the liability is not recorded, it also improves the return on capital employed, as the asset base is lower. Hence following substance over form is key in showing a fair presentation of the financial statements of an entity.

Case study: Repo 105

After the investment bank, Lehman Brothers, collapsed in 2008 it was discovered that the bank had used a transaction known as ‘Repo 105’ to raise short term finance. Financial assets were swapped for cash but with an agreement to buy them back at a future date. The substance of this transaction is that the ‘seller’ continues to control the asset, so it remains in the statement of financial position. The cash is recorded as a liability.

However, Lehman Brothers transferred assets worth 105% of the cash it received in return. Because of this, under the rules in US GAAP it was able to record the transaction as a sale on the grounds that technically it had lost control of the assets and no longer owned them. Therefore the cash received was recorded as an asset rather than a liability and the bank’s liabilities were significantly understated and it was able to mislead investors and lenders about its true financial position.

4 Qualitative characteristics of financial information

Section overview

- Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.
- The two fundamental qualitative characteristics are: relevance and faithful representation.
- The four enhancing qualitative characteristics are: comparability, verifiability, timeliness and understandability.

The IASB’s Conceptual Framework for Financial Reporting sets out and explains the qualitative characteristics of useful financial information.

There are two fundamental qualitative characteristics: relevance and faithful representation. Information must be possess these characteristics in order to be useful.
There are four enhancing qualitative characteristics: comparability, verifiability, timeliness and understandability. These qualities enhance the usefulness of financial information.

4.1 Relevance

Relevant financial information has predictive value, confirmatory value, or both.

**Definition**

Relevance. Relevant financial information is capable of making a difference in the decisions made by users. (Conceptual Framework)

Information on financial position and performance is often used to predict future position and performance and other things of interest to the user, e.g. likely dividend, wage rises. Financial information is also used to confirm (or change) users’ past conclusions about an entity’s financial performance or financial position.

Information can have both predictive value and confirmatory value. For example, revenue for the current year can be used to predict revenue for next year. Actual revenue for the current year can also be compared with expected revenue that was predicted using last year’s financial statements.

4.1.1 Materiality

The relevance of information is affected by its materiality.

**Definition**

Materiality. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. (Conceptual Framework)

The Conceptual Framework explains that materiality is entity-specific. It depends on the nature or size (or both) of items taken in the context of an individual entity’s financial report.

Information may be judged relevant simply because of its nature, even though the amounts involved may be small in relation to the financial statements as a whole (e.g. remuneration of management). In other cases, both the nature and materiality of the information are important. Materiality is not a primary qualitative characteristic itself because it is merely a threshold or cut-off point.

4.2 Faithful representation

To be useful, financial information must faithfully represent the economic phenomena that it purports to represent. The user must be able to depend on it being a faithful representation.

**Definition**

Faithful representation. A faithful representation is complete, neutral and free from error. A complete depiction includes all the information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A neutral depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users.

Free from error means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

(Conceptual Framework)
4.3 **Comparability**

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

The consistency of treatment is therefore important across like items over time, within the entity and across all entities.

The **disclosure of accounting policies** is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

Comparability is **not the same as uniformity**. For information to be comparable, like things must look alike and different things must look different. Comparability is not enhanced by making unlike items look alike. Therefore entities should change accounting policies if they become inappropriate.

Corresponding information for **preceding periods** should be shown to enable comparison over time.

4.4 **Verifiability**

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent.

Verifiability means that different knowledgeable and independent observers could reach consensus (not necessarily complete agreement) that a particular depiction is a faithful representation.

4.5 **Timeliness**

Timeliness means having information available to users in time to be capable of influencing their decisions.

Generally, the older the information is, the less useful it is. However, older financial information may still be useful for identifying and assessing trends (for example, growth in profits over a number of years).

4.6 **Understandability**

Classifying, characterising and presenting information clearly and concisely makes it **understandable**.

Some information is inherently complex and difficult to understand. Excluding this information from the financial statements would make them more understandable, but they would also be incomplete and potentially misleading.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. Users may sometimes need to seek help from an adviser in order to understand information about complex economic phenomena.

4.7 **Applying the qualitative characteristics**

Information must be both relevant and faithfully represented if it is to be useful. In practice, an entity must often find a balance between the two, with the aim of presenting the most relevant information that can be faithfully represented.

The same principle applies to the enhancing qualitative characteristics. Sometimes, one characteristic may have to be diminished in order to maximise another. For example, applying a new standard may reduce comparability in the short term, but may improve relevance or faithful representation in the longer term.
5 Setting of International Financial Reporting Standards

Section overview

- IFRS are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.

5.1 Due process

The due process in developing an accounting standard has six stages as follows:

**Step 1** Setting the agenda. The IASB evaluates the merits of adding a potential item to its agenda mainly by reference to the needs of investors.

The IASB considers:

- the relevance to users of the information and the reliability of information that could be provided
- whether existing guidance is available
- the possibility of increasing convergence
- the quality of the standard to be developed
- resource constraints.

The IFRS Advisory Council and the IFRS Interpretations Committee, other standard-setters and other interested parties may have made comments on accounting issues that could become potential agenda items.

**Step 2** Planning the project. When adding an item to its work agenda, the IASB considers whether to conduct the project alone or jointly with another standard setter. A working group is usually formed at this stage and the project plan is developed.

**Step 3** Developing and publishing the discussion paper. It is not mandatory for the IASB to issue a discussion paper in the development of a standard, but it is usual practice where there is a major new topic being developed and the IASB wish to set out their position and invite comments at an early stage in the process. Typically, a discussion paper includes:

- a comprehensive overview of the issue;
- possible approaches in addressing the issue;
- the preliminary views of its authors or the IASB; and
- an invitation to comment.

**Step 4** Developing and publishing the exposure draft. This is a mandatory step in the due process. Regardless of whether a discussion paper has been published, the exposure draft is the IASB’s main means of consulting the public on the proposed standard. The exposure draft sets out the proposed standard in detail. The development of the exposure draft begins with the IASB considering the following:

- issues on the basis of staff research and recommendations;
- comments received on the discussion paper (if one was published)
- suggestions made by the IFRS Advisory Council, working groups, other standard-setters and public meetings where the proposed standard was discussed.

Once the exposure draft has been published the IASB again invites comments.
Step 5  **Developing and publishing the standard.** The development occurs at IASB meetings when the IASB considers the comments received on the exposure draft. The IASB must then consider whether a second exposure draft should be published. The IASB needs to:

- identify substantial issues that emerged during the comment period on the exposure draft that it had not previously considered
- assess the evidence that has been considered
- evaluate whether it has sufficiently understood the issues and obtained the views of constituents
- consider whether the various viewpoints were aired in the exposure draft and adequately discussed and reviewed in the basis for conclusions.

If the IASB decide that the exposure draft should be republished then the same process should be followed as for the first exposure draft. Once the IASB is satisfied that the issues raised have been dealt with, the IFRS is drafted.

Step 6  **After the standard is issued.** After an IFRS is issued the IASB hold regular meetings with interested parties, including other standard-setting bodies, to help understand unanticipated issues related to the practical implementation and potential impact of its proposals. If there are concerns about the quality of the standard from the IFRS Advisory Council, the IFRS Interpretations Committee, standard-setters and constituents, then the issue may be added to the IASB agenda and the process reverts back to Step 1.

The standard setting process can be illustrated in the diagram below:
5.2 Consultation with national standard-setters

The development of an IFRS involves an open, public process of debating technical issues and evaluating input sought through several mechanisms. Opportunities for interested parties to participate in the development of IFRS would include, depending on the nature of the project:

(a) Participation in the development of views as a member of the IFRS Advisory Council
(b) Participation in advisory groups
(c) Submission of a comment letter in response to a discussion document
(d) Submission of a comment letter in response to an Exposure Draft
(e) Participation in public hearings
(f) Participation in field visits and field tests

The IASB publishes an annual report on its activities during the past year and priorities for next year. This report provides a basis and opportunity for comment by interested parties. In addition, it has recently changed its Constitution so that it is required to undertake a public consultation on its future technical agenda every three years. The first of these public consultations will take place in the second half of 2011.

The IASB reports on its technical projects in its quarterly newsletter, IASB Insight and on its Website. It also publishes a report on IASB decisions immediately after each IASB meeting in its newsletter IASB Update.

5.3 Standards currently in issue

The current list of International Accounting Standards and International Financial Reporting Standards is as follows: (Note that the new standards issued during 2010/11 and the revisions made to existing standards in 2010/11 do not come into force until after 1 July 2012.)

<table>
<thead>
<tr>
<th>International Accounting Standards</th>
<th>Date of issue</th>
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</thead>
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<tr>
<td>IAS 1 (revised) Presentation of financial statements</td>
<td>Sept 2007</td>
</tr>
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<td>IAS 2 Inventories</td>
<td>Dec 2003</td>
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<td>IAS 8 Accounting policies, changes in accounting estimates and errors</td>
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<td>IAS 10 Events after the reporting period</td>
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<td>IAS 11 Construction contracts</td>
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<td>IAS 20 Accounting for government grants and disclosure of government assistance</td>
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<td>IAS 21 The effects of changes in foreign exchange rates</td>
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<td>IAS 23 (revised) Borrowing costs</td>
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<td>IAS 26 Accounting and reporting by retirement benefit plans</td>
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<tr>
<td>IAS 27 (revised) Separate financial statements (previously Consolidated and separate financial statements)</td>
<td>May 2011</td>
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<tr>
<td>IAS 28 (revised) Investments in associates and joint ventures (previously Investments in</td>
<td>May 2011</td>
</tr>
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</table>
## International Accounting Standards

<table>
<thead>
<tr>
<th>Standard</th>
<th>Description</th>
<th>Date of Issue</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAS 29</td>
<td>Financial reporting in hyperinflationary economies</td>
<td>Jan 1995</td>
</tr>
<tr>
<td>IAS 31</td>
<td>Interests in joint ventures</td>
<td>Dec 2003</td>
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<td>IAS 32</td>
<td>Financial instruments: presentation</td>
<td>Dec 2003</td>
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<td>IAS 33</td>
<td>Earnings per share</td>
<td>Dec 2003</td>
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<td>IAS 34</td>
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<td>Feb 1998</td>
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<td>IAS 36</td>
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<td>IAS 39</td>
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<td>Investment property</td>
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<td>IAS 41</td>
<td>Agriculture</td>
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<td>IFRS 1 (revised)</td>
<td>First time adoption of International Financial Reporting Standards</td>
<td>Nov 2008</td>
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<td>IFRS 2</td>
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<td>IFRS 4</td>
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<tr>
<td>IFRS 5</td>
<td>Non-current assets held for sale and discontinued operations</td>
<td>Mar 2004</td>
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<td>IFRS 6</td>
<td>Exploration for and evaluation of mineral resources</td>
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<td>IFRS 7</td>
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<td>IFRS 8</td>
<td>Operating segments</td>
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<td>IFRS 9</td>
<td>Financial instruments</td>
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<td>IFRS 10</td>
<td>Consolidated financial statements</td>
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<td>IFRS 11</td>
<td>Joint arrangements</td>
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<tr>
<td>IFRS 12</td>
<td>Disclosures of interests in other entities</td>
<td>May 2011</td>
</tr>
<tr>
<td>IFRS 13</td>
<td>Fair value measurement</td>
<td>May 2011</td>
</tr>
<tr>
<td>IFRS for SMEs</td>
<td>International Financial Reporting Standard for small and medium sized entities</td>
<td>July 2009</td>
</tr>
</tbody>
</table>

### 5.4 Alternative treatments

Many of the old standards permitted two accounting treatments for like transactions or events. One treatment was designated as the **benchmark treatment** (effectively the **preferred treatment**) and the other was known as the **alternative treatment**. This is no longer the case. The last standard to have a benchmark alternative was IAS 23 which has now been revised to remove the benchmark treatment. Under the revised standard allowable borrowing costs **must** be capitalised. However, some standards do still allow more than one policy – for instance, IAS 16 allows property, plant and equipment to be carried at cost or revalued amount.

### 5.5 Interpretation of IFRS

The IFRS Interpretations Committee (as discussed in chapter 2) has the responsibility for issuing additional guidance on the application of an accounting standard where unsatisfactory or conflicting interpretations...
5.6 Worldwide effect of IFRS and the IASB

The IASB, and before it the IASC, has now been in existence for around 25 years, and it is worthwhile considering the effect it has had in that time.

As far as Europe is concerned, the consolidated financial statements of many of Europe's top multinationals are now prepared in conformity with national requirements, EC directives and IFRS. Furthermore, IFRS are having a growing influence on national accounting requirements and practices. Many of these developments have been given added impetus by the internationalisation of capital markets.

Australia has wholly adopted IFRS and issues Australian Equivalent International Financial Reporting Standards (AIFRS). The AASB adopted IFRS for annual reporting periods for companies from 1 January 2005. This means that all general financial purpose statements prepared by for-profit entities prepared in accordance with AASB are also in accordance with IFRS.

In Japan, the influence of the IASC had, until recently, been negligible. This was mainly because of links in Japan between tax rules and financial reporting. The Japanese Ministry of Finance set up a working committee to consider whether to bring national requirements into line with IFRS. The Tokyo Stock Exchange has announced that it will accept financial statements from foreign issuers that conform with home country standards.

This was widely seen as an attempt to attract foreign issuers, in particular companies from Hong Kong and Singapore. As these countries base their accounting on international standards, this action is therefore implicit acknowledgement by the Japanese Ministry of Finance of IFRS requirements. More recently the Accounting Standards Board of Japan (ASBJ) has announced that Japanese listed companies meeting certain criteria may prepare their accounts under IFRS from fiscal years ended 31 March 2010. Full IFRS adoption is not expected to be achieved until 2016.

Until recently, the US was one of the few countries in which IFRS financial statements were not accepted. However, over the last ten years the US authorities have moved significantly closer to adopting IFRS. Convergence of IFRS and US GAAP is discussed in the following section.

5.7 Effect of harmonisation on companies

There are two main ways in which an individual country can harmonise its national GAAP with IFRS. It can require some or all entities (usually listed companies) to comply with IFRS from a particular date. Alternatively, it can converge its domestic standards with IFRS over a period of time, typically in stages. Obviously, the effect on individual companies is less dramatic and easier to manage if countries choose the second of these routes to harmonisation.

Where a company has to change from a national GAAP to IFRS on a particular date it has to deal with a number of practical issues. Typically, the main issues are as follows:

(a) Management, internal accounts staff and auditors need to be fully trained in IFRS. While there may be broad similarities between domestic standards and IFRS, there are frequently numerous differences in the detail.

(b) Accounting systems and information systems may need to be upgraded to deal with more complex or different reporting requirements.

(c) It is important to communicate with stakeholders (particularly investors, lenders and their advisors) to prepare them for the possible effect of the change on the entity's reported results and financial position.

(d) The change to IFRS affects reported profits and net assets. Management remuneration may depend on a certain level of profits or on increases in profits. Debt covenants (agreements with lenders) may depend on a company maintaining a key level of assets to liabilities, or debt to equity. Remuneration schemes and debt covenants may need to be re-negotiated.
(e) IFRS disclosure requirements may be far more onerous than those of national GAAP. Preparers need to make sure that they have all the necessary information, bearing in mind that they will need to present at least one set of comparative figures under IFRS, as well as the figures for the current year.

(f) It may still be necessary to prepare accounts under national GAAP for the tax authorities.

A 2009 AASB publication *IFRS Adoption in Australia* summarised the outcomes of the change to IFRS from 2005. The benefits have been:

- Australian entities’ financial reports are more readily understood world wide;
- there are synergies in the preparation, audit and analysis of Australian financial reports for entities that are part of a multinational group; and
- improved reporting of financial instruments (an area in which IFRS was more comprehensive than Australian GAAP).

The disadvantages have been:

- the initial costs of adoption, particularly for banks and insurers in implementing the standards on financial instruments
- the pace of change: companies have had to deal with numerous amendments to IFRS that are often driven by issues that are not a concern in Australia
- accounting and reporting issues that are important to Australian companies (for example, for extractive industries) are not a priority for the IASB.

**Case study: Reporting under IFRS**

When companies adopt IFRS for the first time, they are required to include a reconciliation between profit after tax as previously reported and profit after tax under IFRS.

An extract from the financial statements of the Westfield Group for the year ended 31 December 2005 (the first full year of applying IFRS) is shown below. The reconciliation statement is for the year ended 31 December 2004 (the previous year).

<table>
<thead>
<tr>
<th>b) Reconciliation of profit after tax between AGAAP and AIFRS</th>
<th>Consolidator 31 Dec 04 $Million</th>
<th>Parent Company 31 Dec 04 $Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit after tax attributed to Members as previously reported under AGAAP</td>
<td>832.9</td>
<td>347.7</td>
</tr>
<tr>
<td>Investment property revaluations⁽¹⁾</td>
<td>2,298.1</td>
<td>-</td>
</tr>
<tr>
<td>Minority interest property revaluations⁽¹⁾</td>
<td>(141.2)</td>
<td>-</td>
</tr>
<tr>
<td>Investment property revaluations attributable to equity accounted associates⁽¹⁾</td>
<td>462.2</td>
<td>-</td>
</tr>
<tr>
<td>Deferred tax charge⁽²⁾</td>
<td>(358.4)</td>
<td>(29.0)</td>
</tr>
<tr>
<td>Goodwill on acquisitions (due to the recognition of deferred tax liabilities) written off⁽³⁾</td>
<td>(460.0)</td>
<td>-</td>
</tr>
<tr>
<td>Others AIFRS adjustments</td>
<td>(3.2)</td>
<td>(0.2)</td>
</tr>
<tr>
<td><strong>Profit after tax attributable to members under AIFRS</strong></td>
<td>2,630.4</td>
<td>518.5</td>
</tr>
</tbody>
</table>

⁽¹⁾ AASB to "Investment Property" requires revaluation increment/decrement to be recognised through the income statement. Under AGAAP revaluation movements were recognised in the asset revaluation reserve.

Profit for the year is significantly higher under IFRS than under Australian GAAP (AGAAP). This is because of the effect of IFRS on the group’s investment properties (see the notes to the statement). At this time, property prices were steadily rising.

Below is shown another reconciliation statement, this time from the financial statements of Telstra Corporation Limited for the year ended 30 June 2005 (this company’s first full year of reporting under IFRS was the year to 30 June 2006). Telstra Corporation is in a different business from Westfield and the effect of adopting IFRS is not as pronounced. There is no one significant item, but a number of differences and the overall effect is to reduce profit for the year by $129 million (or by just under 3%).
Accounting standards and concepts

6 International harmonisation

Section overview
- Although the IASB has faced criticism and political pressures, there is broad general support for its overall objective of implementing a single set of high quality, global financial reporting standards.

Arguably, the development of high quality International Financial Reporting Standards has been a major factor in making international harmonisation possible. International standards have to be perceived as at least as good as, or preferably better than the national GAAP that they replace, otherwise they will not be accepted by the world’s major stock exchanges.

This section looks at the progress that has been made towards harmonisation and the obstacles that still remain.

6.1 The IASB and IOSCO

The International Organisation of Securities Commissions (IOSCO) is the representative of the world’s securities markets’ regulators. High quality information is vital for the operation of an efficient capital market, and differences in the quality of the accounting policies and their enforcement between countries leads to inefficiencies between markets. IOSCO has been active in encouraging and promoting the improvement and quality of IFRS over the last 10 years. This commitment was evidenced by the agreement
between the International Accounting Standards Committee (IASC) (the predecessor of the IASB) and IOSCO to work on a program of 'core standards' which could be used by publicly listed entities when offering securities in foreign jurisdictions.

The 'core standards' project resulted in fifteen new or revised IFRS and was completed in 1999 with the issue of IAS 39 Financial instruments: recognition and measurement. IOSCO spent a year reviewing the results of the project and released a report in May 2000 which recommended to all its members that they allow multinational issuers to use IFRS, as supplemented by reconciliation, disclosure and interpretation where necessary to address outstanding substantive issues at a national or regional level.

IASB staff and IOSCO continue to work together to resolve outstanding issues and to identify areas where new IASB standards are needed.

6.2 Barriers to harmonisation

There are undoubtedly many barriers to full international harmonisation. Problems include the following:

(a) **Different purposes of financial reporting.** In some countries the purpose is solely for tax assessment, while in others it is for investor decision-making.

(b) **Different legal systems.** These prevent the development of certain accounting practices and restrict the options available.

(c) **Different user groups.** Countries have different ideas about who are the relevant user groups and their respective importance. In the US investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile.

(d) **Needs of developing countries.** Developing countries are clearly behind in the standard-setting process and they need to develop the basic standards and principles already in place in most developed countries.

(e) **Nationalism** is demonstrated in an unwillingness to accept another country's standard.

(f) **Cultural differences** result in objectives for accounting systems differing from country to country.

(g) **Unique circumstances.** Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports, for example hyperinflation, civil war, currency restriction and so on.

(h) **The lack of strong accountancy bodies.** Many countries do not have strong independent accountancy or business bodies which would press for better standards and greater harmonisation.

These are difficult problems to overcome, and yet attempts are being made continually to do so. We must therefore consider what the perceived advantages of harmonisation are, which justify so much effort.

6.3 Advantages of global harmonisation

In spite of all these difficulties, why is harmonisation perceived as so desirable? The advantages are based on the benefits to users and preparers of financial statements. We discussed many of these in Chapter 2.

**Question 4: Harmonisation**

Suggest reasons why harmonisation is seen as desirable on a global basis.

*(The answer is at the end of the chapter)*

6.4 Political problems

Any international body, whatever its purpose or activity, faces enormous political difficulties in attempting to gain *international consensus* and the IASB is no exception to this. How can the IASB reconcile the financial reporting situation between economies as diverse as third-world developing countries and sophisticated first-world industrial powers?

**Developing countries** are suspicious of the IASB, believing it to be dominated by the USA. This arises because acceptance by the USA listing authority, the Securities and Exchange Commission (SEC), of IFRS has been seen as a major hurdle to be overcome. For all practical purposes it is the American market which...
must be persuaded to accept IFRS. Developing countries have been catered for to some extent by the issue of a Standard on 

agriculture, which is generally of much more relevance to such countries.

There are also tensions between the UK/US model of financial reporting and the European model. The UK/US model is based around investor reporting, whereas the European model is mainly concerned with tax rules, so shareholder reporting has a much lower priority.

Although the EU countries have now adopted IFRS for the consolidated financial statements of listed entities, the Regulation actually requires listed companies to adopt the standards and Interpretations that have been 

endorsed by the European Financial Reporting Advisory Group (EFRAG). Many have feared that in practice this might lead to EFRAG effectively becoming a European standard setting body and that eventually Europe might 

adopt its own variant of IFRS. This has not happened. However, 

fair value accounting for financial instruments has been a very controversial issue. The hedge accounting provisions of IAS 39 Financial instruments: Recognition and measurement have still not been endorsed.

The 

global financial crisis 

of 2008 intensified the above problems. Because IFRS requires most financial assets to be measured at fair value, entities had to record huge losses on remeasurement when share prices fell. Many argued that the IASB had contributed to the crisis by requiring the use of fair values 

(sometimes called 'mark to market' accounting). Some politicians, particularly within Europe, began to press the IASB to amend its financial instruments standards urgently so that companies would not have to 

recognise changes in the fair value of financial instruments in profit or loss. The IASB responded by 

accelerating its project to develop a new standard on financial instruments (due to come into force in 2015) but has not retreated from its basic position, ie, that most financial assets should be measured at fair value.

Many also voiced general criticisms of the IASB and the IFRS Foundation:

(a) it is not publicly accountable
(b) its operating procedures are not sufficiently transparent and do not allow enough consultation
(c) it continues to be dominated by US interests and has prioritised convergence to US GAAP at the expense of other projects

The IASB has responded to these criticisms by making some changes in its constitution and operating procedures. These include the following:

(a) A Monitoring Board has been set up to provide a formal link between the Trustees and public authorities. The Monitoring Board participates in the process for appointing Trustees and approves their appointment. It also advises the Trustees, who are required to report to it annually, and review their work. The Monitoring Board has six members drawn from the European Commission, IOSCO, the US Securities and Exchange Commission (SEC) and other regulatory bodies.

(b) The composition of the IASB has changed. Originally, the IASB had 14 members, of which 12 were full time and two were part time. Although most developed countries were represented, in practice over half the members came from North America. From 2012 onwards, the IASB will have 16 members, of which up to three may be part-time. As before, they will be appointed on the basis of their experience and technical expertise and will be selected so that there is a mix of auditors, preparers of financial statements, users of financial statements and academics. However, in addition there should normally be: four members from the Asia/Oceania region; four members from Europe; four members from North America; one member from Africa; one member from South America; and two members appointed from any area, subject to maintaining overall geographical balance.

(c) Three-yearly public consultations on the IASB’s technical agenda have been introduced
(d) A provision for accelerated due process has been introduced for use in exceptional circumstances

Despite the criticisms, there is still broad general support for the IASB’s overall objective of implementing a single set of high quality, global financial reporting standards. There are various bodies which are working on different aspects of harmonisation and these are discussed below.
6.5 The European Commission (EC) regulation

Section overview

- The EC has required that since 2005 consolidated accounts of all listed companies should comply with IFRS.

As we have already seen, the EC regulations form one part of a broader program for the harmonisation of company law in member states. The Commission is uniquely the only organisation to produce international standards of accounting practice that are legally enforceable, in the form of directives that must be included in the national legislation of member states. The directives have been criticised as they might become constraints on the application of world-wide standards and bring accounting standardisation and harmonisation into the political arena.

The EC adopted a regulation stating that from 2005 consolidated accounts of listed companies are required to comply with IFRS. The implications of this are far reaching.

Many commentators believe that, in the light of the above, it is only a matter of time before national standard-setting bodies are, in effect, replaced by the IASB and national standards fall into disuse. However, national standards were designed for the national environment, which may include small companies, the not-for-profit private sector and/or the public sector. Moreover, the IASB will need input and expertise from valued national standard-setters.

6.6 Convergence with US GAAP

Section overview

- Convergence with EC countries has been more or less put on hold while IFRS moves closer to US GAAP.

6.6.1 Norwalk agreement

In October 2002, the IASB reached an agreement with the Financial Accounting Standards Board (FASB) in the US (the ‘Norwalk’ agreement) to undertake a short-term convergence project aimed at removing a variety of individual differences between US GAAP and international standards.

6.6.2 Principles-based approach

In March 2003, an ‘identical style and wording’ approach was agreed for standards issued by FASB and the IASB on joint projects. Revised business combinations standards were issued as a result of this approach in January 2008.

The FASB also recognised the need to follow a ‘principles-based’ approach to standard-setting (as the IASB has always done) in the light of recent corporate failures and scandals which have led to criticism of the ‘rules-based’ approach.

Some examples of high profile global collapses include Enron and Lehman Brothers in the US and, in Australia, Great Southern Ltd, Australia’s largest forestry investment scheme, and investment bank Babcock and Brown Ltd, both in March 2009. However, in the banking industry, the argument has almost reversed, with more call now for tougher regulation, ie a rules-based approach.

6.6.3 Common conceptual framework

In October 2004, the IASB and FASB agreed to develop a common conceptual framework which would be a significant step towards harmonisation of future standards. The project is ongoing and was discussed in chapter 3.

6.6.4 Memorandum of understanding

In February 2006, the two Boards signed a ‘Memorandum of Understanding’. This laid down a ‘roadmap of convergence’ between IFRS and US GAAP in the period 2006-2008.
The aim was to remove by 2009 the requirement for foreign companies reporting under IFRS and listed on a US stock exchange to have to prepare a reconciliation to US GAAP.

Events moved faster than expected, and in November 2007 the US Securities and Exchange Commission (SEC) decided to allow non-US filers to report under IFRS for years ended after 15 November 2007 with no reconciliation to US GAAP.

In June 2010 the convergence strategy documented in the Memorandum of Understanding was modified. The modified work plan retains a target completion date of June 2011 or earlier for the MoU projects for which “the need for improvement of both IFRS and U.S. GAAP is the most urgent”, however it defers less important work until after this date.

Consultation is also underway on the possibility of the use of IFRS by US filers. In November 2008, the SEC published a proposal, titled *Roadmap for the Potential Use of Financial Statements Prepared in accordance with International Financial Reporting Standards by U.S. Issuers*. The proposed roadmap sets out milestones that, if achieved, could lead to the adoption of IFRS in the US in 2014. It also proposes to permit the early adoption of IFRS from 2010 for some US entities. The Commission formally met again to discuss IFRS in 2010 and issued a statement expressing its strong commitment to the development of a single set of high-quality globally accepted accounting standards. It further clarified that upon completion of the MoU modified workplan by June 2011, the Commission would be in a position to determine whether to incorporate IFRS into the US financial reporting system. Should this determination occur in 2011, US issuers would be required to adopt IFRS no earlier than 2015, which allows approximately four to five years for transition.

### 6.7 Dialogue with other key standard-setters

The IASB maintains a policy of dialogue with other key standard-setters around the world, in the interest of harmonising standards across the globe.

Partner standard-setters are often involved in the development of Discussion Papers and Exposure Drafts on new areas. To ensure an international basis, both the members of the IASB and the Trustees of the IFRS Foundation are to be taken from a broad geographical range which is specified (see sections 2.1 and 2.2, chapter 2).

### 6.8 The situation today and in the future

Many organisations committed to global harmonisation have done a great deal of work towards this goal. It is the case at present, however, that some disagreements still exist between countries and organisations about the way forward. One of the major gulfs is between the reporting requirements in developed countries and those in non-developed countries. It will be some time before these difficulties can be overcome. The IASB is likely to be the lead body in attempting to do so, as discussed above.
Key chapter points

- A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.
- There are arguments for and against having accounting standards at all.
- Accounting policies have two attributes:
  - Relevance
  - Reliability
- **Going concern** is the underlying assumption in preparing financial statements.
- Financial information (other than information about cash flows) should be prepared on the **accruals** basis.
- Qualitative characteristics are the attributes that make the information provided in financial statements useful to users.
- The two fundamental qualitative characteristics are: **relevance** and **faithful representation**.
- The four enhancing qualitative characteristics are: **comparability**, **verifiability**, **timeliness** and **understandability**.
- IFRS are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.
- Although the IASB has faced criticism and political pressures, there is broad general support for its overall objective of implementing a single set of high quality, global financial reporting standards.
- The EC has required that since 2005 consolidated accounts of all listed companies should **comply with IFRS**.
- Convergence with EC countries has been more or less put on hold while **IFRS moves closer to US GAAP**.
Quick revision questions

1. What type of accounting system does the following statement describe?
   'A system that contains rules dealing with particular accounting issues. As a new issue arises, a new rule is developed to deal with it.'
   A a principles-based system
   B a rules-based system

2. What is the ‘true and fair override’?
   A the requirement for all published financial statements to show a true and fair view
   B the exception to applying accounting standards if following them does not show a true and fair view

3. Which of the following statements represents a disadvantage of the use of accounting standards?
   A standards reduce variations in methods used to produce accounts
   B standards oblige companies to disclose their accounting policies
   C standards are a less rigid alternative to legislation
   D standards may tend towards rigidity in applying the rules

4. There are four enhancing qualitative characteristics of useful financial information. What are those characteristics?
   A comparability, understandability, completeness, neutrality
   B comparability, timeliness, verifiability, understandability
   C going concern, accruals, completeness, verifiability
   D substance over form, neutrality, going concern, accruals

5. What is the accounting concept called which requires assets to be valued at their net book value, rather than their break-up value?
   A materiality
   B going concern
   C historical cost
   D substance over form

6. What is the accounting concept called that requires income and expenses to be matched in the period in which they occur, rather than when the cash is received or paid?
   A accruals
   B neutrality
   C materiality
   D faithful representation

7. What is the correct order for the process of issuing a new IFRS by the IASB?
   A Exposure Draft, Discussion Paper, Standard,
   B Discussion Paper, Standard
   C Exposure Draft, Discussion Paper, Review
   D Discussion Paper, Exposure Draft, Standard

8. How many IFRS have been published by the IASB (not counting the IFRS for SMEs)?
   A 41
   B 13
   C 37
   D 42
9 Which of the following is a benefit to harmonisation?

A increased training of staff to deal with new accounting standards
B ability of investors to compare cross border financial statements
C different countries have different legal systems for accounting which need to be amended
D amendment of tax systems in different countries to align with accounting requirements

10 With which accounting body is the IASB developing a common conceptual framework?

A the Accounting Standards Board
B the European Commission
C the Financial Accounting Standards Board
D the OECD
### Answers to quick revision questions

1. B  A principles based system involves applying underlying general principles to all transactions.

2. B  All published financial statements must be true and fair (or fairly presented). A true and fair override arises where a company does not follow the requirements of an IFRS in order to achieve a true and fair presentation.

3. D  The other arguments are all in favour of accounting standards.

4. B  These are the four qualitative characteristics contained within the Conceptual Framework which enhance the usefulness of information that is relevant and faithfully represented.

5. B  Where a business is a going concern, it is anticipated that the business will continue to trade for the foreseeable future (being at least 12 months). Therefore assets should be measured at their value to the business (carrying value) rather than at their sale value (break-up value).

6. A  The accruals concept requires that the effects of transactions are recognised when they occur, so meaning that credit sales and purchases, for example, are included in the income statement for a period.

7. D  Although the issue of a discussion paper is not a mandatory step in due process, this would be issued before the (mandatory) exposure draft, and in due course a final standard.

8. B  13 IFRS have been published by the IASB.

9. B  Investors will benefit as financial statements will be more comparable.

10. C  The FASB is the US standard setter. It is working with the IASB on a number of projects, including that to develop a new conceptual framework.
Answers to chapter questions

1 (a) This standard is a hybrid of the two. It contains a principle (lease classification depends on whether the lease transfers the risks and benefits of ownership to the lessee). It also contains rules for determining whether or not the risks and benefits are likely to have been transferred.

(b) There is a danger that management might ignore the basic principle and simply apply the rules, particularly if this improved the entity's financial position. It is possible to structure a finance lease agreement so that (for example), the present value of the minimum lease payments is 89 per cent of the fair value of the leased asset. A lease that was in substance a finance lease could then be treated as an operating lease for the purpose of the financial statements.

2 (a) This is a change in presentation, so it does represent a change of accounting policy
(b) This is a change of accounting estimate, not a change of accounting policy
(c) This is a change of measurement basis, so it does represent a change of accounting policy

3 (a) If the business is to be closed down, the remaining three machines must be valued at the amount they will realise in a forced sale, i.e. \(3 \times \$60 = \$180\).

(b) If the business is regarded as a going concern, the inventory unsold at 31 December will be carried forward into the following year, when the cost of the three machines will be matched against the eventual sale proceeds in computing that year's profits. The three machines will therefore be valued at cost, \(3 \times \$100 = \$300\).

4 (a) Investors, both individual and corporate, would like to be able to compare the financial results of different companies internationally as well as nationally in making investment decisions. Differences in accounting practice and reporting can prove to be a barrier to such cross-border analysis. There is a growing amount of investment across borders and there are few financial analysts able to follow shares in international markets. For example, it is not easy for an analyst familiar with UK accounting principles to analyse the financial statements of a Dutch or German company. Harmonisation would therefore be of benefit to such analysts.

(b) Multinational companies would benefit from harmonisation for many reasons including the following:
(i) Better access would be gained to foreign investor funds.
(ii) Management control would be improved, because harmonisation would aid internal communication of financial information.
(iii) Appraisal of foreign entities for takeovers and mergers would be more straightforward.
(iv) It would be easier to comply with the reporting requirements of overseas stock exchanges.
(v) Consolidation of foreign subsidiaries and associated companies would be easier.
(vi) A reduction in audit costs might be achieved.
(vii) Transfer of accounting staff across national borders would be easier.

(c) Governments of developing countries would save time and money if they could adopt international standards and, if these were used internally, governments of developing countries could attempt to control the activities of foreign multinational companies in their own country. These companies could not 'hide' behind foreign accounting practices which are difficult to understand.
(d) **Tax authorities.** It will be easier to calculate the tax liability of investors, including multinationals who receive income from overseas sources.

(e) **Regional economic groups** usually promote trade within a specific geographical region. This would be aided by common accounting practices within the region.

(f) **Large international accounting firms** would benefit as accounting and auditing would be much easier if similar accounting practices existed throughout the world.
Chapter 5
Elements of financial statements and their recognition criteria

<table>
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<tr>
<th>Learning objectives</th>
<th>Reference</th>
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<td>Elements of financial statements and their recognition criteria</td>
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</tr>
<tr>
<td>Define the elements of financial statements</td>
<td>LOS.1</td>
</tr>
<tr>
<td>Identify and define the following elements of financial statements:</td>
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<td>asset</td>
<td>LOS.2.1</td>
</tr>
<tr>
<td>liability</td>
<td>LOS.2.2</td>
</tr>
<tr>
<td>equity</td>
<td>LOS.2.3</td>
</tr>
<tr>
<td>income</td>
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<tr>
<td>expense</td>
<td>LOS.2.5</td>
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<tr>
<td>Identify the financial statements where these elements are recognised</td>
<td>LOS.3</td>
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<tr>
<td>Define the recognition means for an element of the financial statements</td>
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<td>Identify the criteria for recognition of the following elements of the financial statements</td>
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<tr>
<td>asset</td>
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<td>expense</td>
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</table>

Topic list
1. The elements of financial statements
2. Recognition of the elements of financial statements
3. Applying the recognition criteria
4. The main financial statements
In Chapter 3, we looked at the purpose of the IASB's Conceptual Framework. This chapter looks at some of the content of the Conceptual Framework. First, we will examine the main elements of financial statements: assets, liabilities, equity, revenue and expenses.

Second, we will look at the financial statements where these items are recognised and finally, we will look at the recognition criteria for each of the elements of the financial statements.
Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

1. Define an asset. (Section 1.2)
2. Define a liability. (Section 1.2)
3. Define equity. (Section 1.2)
4. What criteria must be met in order for an item to be recognised in the financial statements? (Section 2)
5. Which of the following statements is / are true? (Sections 3.1.1 & 3.1.2)
   I. All assets and liabilities must always be presented in order of liquidity
   II. A liability is always classified as non-current where the amount due is to be settled in more than 12 months
   A. both of them
   B. neither of them
   C. I only
   D. II only
1 The elements of financial statements

1.1 Introduction

Section overview

Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.

In Chapter 3, we discussed the principles of the IASB’s Conceptual Framework for Financial Reporting. This section looks at some of the detail within the Conceptual Framework and examines the definitions of the elements of financial statements.

The Conceptual Framework sets out these elements as follows:

A process of sub-classification then takes place for presentation in the financial statements, e.g. assets are classified by their nature or function in the business to show information in the best way for users to make economic decisions.

1.2 Financial position

We need to define the three terms listed under this heading above.

Definitions

Asset. A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Liability. A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

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

(Conceptual Framework)
These definitions are important, but they do not cover the criteria for recognition of any of these items, which are discussed in the next section of this chapter. This means that the definitions may include items which would not actually be recognised in the statement of financial position because they fail to satisfy recognition criteria particularly, as we will see below, the probable flow of any economic benefit to or from the business.

Whether an item satisfies any of the definitions above will depend on the substance and economic reality of the transaction, not merely its legal form as discussed in the previous chapter.

### 1.3 Assets

We can look in more detail at the components of the definitions given above.

**Definition**

*Future economic benefit.* The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production.

*(Conceptual Framework)*

Assets are usually employed to produce goods or services for customers; customers will then pay for these. *Cash itself* renders a service to the entity due to its command over other resources.

The existence of an asset, particularly in terms of *control*, is not reliant on:

(a) **physical form** (hence patents and copyrights are assets); *nor*

(b) **legal rights** (hence leases can give rise to assets).

Transactions or events *in the past* give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset.

### 1.4 Liabilities

Again we can look more closely at some aspects of the definition. An essential characteristic of a liability is that the entity has a *present obligation*.

**Definition**

*Obligation.* A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

*(Conceptual Framework)*

It is important to distinguish between a present obligation and a *future commitment*. A management decision to purchase assets in the future does not, in itself, give rise to a present obligation. An obligation is something that cannot be avoided.

*Settlement* of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. This may be done in various ways, not just by payment of cash.

Liabilities must arise from *past transactions or events*. In the case of, say, recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability.
1.4.1 Provisions
Is a provision a liability?

Definition
Provision. A present obligation which satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated. (Conceptual Framework)

Question 1: Definite variables
Consider the following situations. In each case, does the company have an asset or liability within the definitions given by the Conceptual Framework? Give reasons for your answer.

(a) Pat Co has purchased a patent for $20,000. The patent gives the company sole use of a particular manufacturing process which will save $3,000 a year for the next five years.

(b) Baldwin Co paid a mechanic $10,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company’s fleet.

(c) Deals on Wheels Co provides a warranty with every car sold.

(The answer is at the end of the chapter)

1.5 Equity
Equity is defined above as a residual, but it may be sub-classified in the statement of financial position into different reserves. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statute or other law, e.g. for the future protection of creditors. The amount shown for equity depends on the measurement of assets and liabilities. It has nothing to do with the market value of the entity’s shares.

1.6 Performance
Profit is used as a measure of performance, or as a basis for other measures (e.g. earnings per share). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

The elements of income and expenses are therefore defined.

Definitions
Income. Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Expenses. Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. (Conceptual Framework)

Income and expenses can be presented in different ways in the statement of comprehensive income, to provide information relevant for economic decision-making. For example, a distinction is made between income and expenses which relate to continuing operations and those which do not.

1.7 Income
Both revenue and gains are included in the definition of income. Revenue arises in the course of ordinary activities of an entity.
**Definition**

**Gains.** Increases in economic benefits. As such they are no different in nature from revenue.

*(Conceptual Framework)*

Gains include those arising on the disposal of non-current assets. The definition of income also includes *unrealised gains*, e.g. on revaluation of marketable securities.

### 1.8 Expenses

As with income, the definition of expenses includes losses as well as those expenses that arise in the course of ordinary activities of an entity.

**Definition**

**Losses.** Decreases in economic benefits. As such they are no different in nature from other expenses.

*(Conceptual Framework)*

Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include *unrealised losses*, e.g. exchange rate effects on borrowings or the downward revaluation of property.

### 1.9 Capital maintenance adjustments

A *revaluation* results in an increase or decrease in equity.

**Definition**

Restatement of assets’ and liabilities’ carrying amounts.

*(Conceptual Framework)*

These increases and decreases meet the definitions of income and expenses. They are *not included* in an entity’s profit or loss for the year under certain concepts of capital maintenance, however, but rather in equity. However, they will be shown in the statement of comprehensive income under the heading of ‘other comprehensive income’.

### 1.10 Section summary

Make sure you learn the important definitions:

- **Financial position:**
  - Assets
  - Liabilities
  - Equity.

- **Financial performance:**
  - Income
  - Expenses.
2 Recognition of the elements of financial statements

Section overview

- Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain **recognition criteria**.

**Definition**

**Recognition.** The process of incorporating into the statement of financial position or statement of comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability.  

(Conceptual Framework)

Regard must also be given to **materiality** as defined in the *Conceptual Framework*.

**Definition**

**Materiality.** Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.  

(Conceptual Framework)

2.1 Probability of future economic benefits

Probability here means the **degree of uncertainty** that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the **characteristics of the entity’s environment** and the **evidence available** when the financial statements are prepared.

2.2 Reliability of measurement

The cost or value of an item, in many cases, **must be estimated**. The *Conceptual Framework* states, however, that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where no reasonable estimate can be made, the item should not be recognised, although its existence should be disclosed in the notes, or other explanatory material.

Items may still qualify for recognition **at a later date** due to changes in circumstances or subsequent events.

2.3 Recognition of items

We can summarise the recognition criteria for assets, liabilities, income and expenses, based on the definition of recognition given above.

<table>
<thead>
<tr>
<th>Item</th>
<th>Recognised in</th>
<th>When</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td>The statement of financial position</td>
<td>It is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.</td>
</tr>
<tr>
<td>Liability</td>
<td>The statement of financial position</td>
<td>It is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.</td>
</tr>
</tbody>
</table>
3 Applying the recognition criteria

3.1 Assets

The Conceptual Framework explains that an asset is not recognised in the statement of financial position (balance sheet) when expenditure has been incurred but it is considered not probable that economic benefits will flow to the entity beyond the current accounting period. Instead, an expense is recognised.

Consider the case of advertising expenditure. The company incurs the cost of having its products and services advertised because management believes that increased sales revenue will result. It could be argued that the advertising meets the definition of an asset: it is a resource controlled by the entity as the result of a past transaction (the contract with the agency and the payment of the fee) and economic benefit is expected to flow to the entity as a result (in the form of increased sales revenue). But the cost of the advertising cannot be capitalised (recognised as an asset), because it fails at least one and probably both of the recognition criteria:

- It is certainly possible that the entity will obtain economic benefit from the expenditure in a future period, but it would normally be quite difficult to argue that an increase in revenue is probable. Even if there is a pattern of increased sales following an advertising campaign, it would be very difficult to prove that a certain number of customers bought a particular product or a service just because they had seen an advert for it (although that may have been a factor, possibly a subconscious one, in their decision).
- In the same way, it would be very difficult to prove that X amount of advertising expenditure resulted in Y amount of additional sales revenue. Therefore the ‘asset’ does not have a cost that can be measured reliably.

Question 2: Research and development expenditure

Below is an extract from the annual report of Woolworths Limited.

Significant Accounting Policies

Research and development

Expenditure on research activities, undertaken with the prospect of gaining new technical knowledge and understanding, is recognised in the profit and loss as an expense as incurred.

Expenditure on development activities, whereby research findings are applied to a plan or design for the production of new or substantially improved products and processes, is capitalised if the product or process is technically and commercially feasible and the consolidated entity has sufficient resources to complete development. The expenditure capitalised includes the cost of materials, direct labour and an appropriate proportion of overheads.

Other development expenditure is recognised in the income statement as an expense as incurred. Capitalised development expenditure is stated at cost less accumulated amortisation and impairment losses.

Explain the reasoning behind these accounting policies.

(The answer is at the end of the chapter)
3.2 Liabilities

A liability is recognised in the statement of financial position (balance sheet) when:

(a) it is **probable** that an outflow of resources embodying economic benefits will result from the settlement of a present obligation; and

(b) the amount at which the liability will be settled can be **measured reliably**.

There are two potential problems here: deciding whether an outflow is probable; and estimating the amount of the liability.

Consider a possible liability arising from a claim against a company. One of its customers has been seriously injured, allegedly as the result of buying and using the company’s products. For there to be a liability, there must be a present obligation to pay damages as a result of a past event (the purchase and use of the products). At the year-end, lawyers advise that there is approximately a 80% chance that the company will be found liable. It is **more likely than not** that the company will have to pay compensation, which will amount to between $50 000 and $100 000.

In this case, there is a liability and it meets the first of the recognition criteria: it is **probable** that there will be an outflow of economic benefit. Because the lawyers have been able to determine a range of possible outcomes the second recognition criteria is met: the amount of the liability **can be measured reliably**.

The company **recognises a provision** (a liability of uncertain timing or amount) for the best estimate of the amount to settle the obligation.

**Question 3: Possible liability**

A customer is making a claim against a company. At the year-end, the company’s lawyers advise that there is approximately a 40% chance that the company will be found liable and will have to pay compensation.

Explain how you would treat the claim in the financial statements for the period.

*(The answer is at the end of the chapter)*

3.3 Equity

The **Conceptual Framework** defines equity as the residual interest in the assets of the entity after deducting all its liabilities. This is a restatement of the basic accounting equation:

\[ \text{ASSETS} - \text{LIABILITIES} = \text{EQUITY} \]

Equity consists of funds contributed by shareholders (share capital), retained earnings and other reserves. Other reserves are normally appropriations of retained earnings.

Equity can be viewed as a type of liability: the amount owed to the equity shareholders (its owners). However, there is a crucial difference between equity and liabilities. For there to be a liability there must be an **obligation**: an outflow of economic benefits that cannot realistically be avoided.

Many companies are financed by a mixture of equity and debt (borrowings).

- Debt finance is a **liability** of the company. The company will eventually have an **obligation to repay the amount**. In almost all cases, the company also has an **obligation to pay interest** on its debt, regardless of the amount of the entity’s profits or losses. There is normally reasonable certainty about the amount that the lenders will receive and about when they will receive it.

- Equity shares give their holders the right to **share in the company’s profit and losses** and (in theory) to influence the policies adopted by management by exercising voting rights. They are **exposed to the risks** and uncertainties of the business. The return on their investment (in the form of dividends) **depends on the company’s results**; in a poor year they may receive nothing. If the company is wound up, they may receive a share of its retained profits, but only after the lenders and other creditors have been paid.

During the last thirty years there has been a growth in the number and complexity of types of financial instrument. For legal reasons, some instruments are called shares although they have the characteristics of debt. Preparers of financial statements should look at the economic substance of the arrangement in order to decide whether a financial instrument is debt (a liability) or equity.
Question 4: Preference shares

A company has two classes of shares: $1 ordinary shares and 6% redeemable preference shares with a nominal value of $1 each. Holders of the preference shares receive a dividend of 6% of the amount of their shareholding each year. For example, a shareholder who held 10,000 preference shares would automatically receive a dividend of $600 each year, regardless of the company’s performance. The preference shares mature in five years’ time: at that date the capital that the holders have invested will be repaid to them.

Are the preference shares part of equity, or a liability? Explain your answer.

(The answer is at the end of the chapter)

3.4 Income

The Conceptual Framework explains that income is recognised when:

(a) there has been an increase in future economic benefits related to an increase in an asset or a decrease of a liability; and

(b) this increase or decrease can be measured reliably.

For example, when an entity makes a sale it recognises revenue and it also recognises an asset: cash or an amount receivable that will eventually be converted into cash. This asset meets the recognition criteria:

- it is probable that there will be an inflow of economic benefit (cash has either already been received or will be received in the near future); and

- the amount can be reliably measured (it is normally a matter of fact and can be verified).

Similarly, when an entity recognises a gain on disposal of an asset it also recognises a net increase in assets: tangible assets decrease, but cash increases by a greater amount.

Determining when to recognise revenue can be a problem. Even a simple sales transaction has several stages: the customer orders the goods; the goods are produced; the goods are delivered to the customer; the customer is invoiced; and the cash is received. In theory, a company could argue a case for recognising a sale at any of these stages, but generally accepted accounting practice is to recognise the revenue when the goods are despatched to the customer. This is the critical event in the earnings cycle. At this point the company has performed its side of the sales contract with the customer and has earned the right to payment.

Some sales transactions are more complicated than this. It is necessary to apply the recognition criteria and to determine the economic substance of the transaction. This may involve determining whether or not:

(a) the entity has transferred the significant risks and rewards of ownership of the goods to the buyer; or

(b) the entity has any continuing managerial involvement or control over the goods sold.

When it is a service that is sold, revenue is recognised as or when the service is performed. For example, revenue from a magazine subscription is recognised over the period of the subscription.

In recent years, there have been several occasions on which companies have adopted controversial accounting policies for revenue recognition (sometimes called ‘aggressive earnings management’). These controversial policies have all involved recognising revenue before it has actually been earned.

Question 5: Airline

Below is an extract from the annual report of the Qantas Group

Statement of significant accounting policies: Revenue Recognition

Passenger, Freight and Tours and Travel Revenue

Passenger, freight and tours and travel revenue is recognised when passengers or freight are uplifted or when tours and travel air tickets and land content are utilised. Unused tickets are recognised as revenue using estimates based on the terms and conditions of the ticket.

Explain the reasoning behind this accounting policy, applying the recognition criteria in the Conceptual Framework.

(The answer is at the end of the chapter)
3.5 Expenses

The Conceptual Framework explains that expenses are recognised when:

(a) there has been a decrease in future economic benefits related to a decrease in an asset or an increase in a liability; and

(b) this increase or decrease can be measured reliably.

For example, when an entity incurs office expenses such as light and heat it recognises the expense and it also recognises a liability: the amount payable to the supplier. This liability meets the recognition criteria:

- it is probable that there will be an outflow of economic benefit (the entity must eventually pay the amount it owes to the supplier); and
- the amount can be reliably measured (the amount payable will either have been invoiced or can be estimated based on past experience).

Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income, (the matching of costs and revenues). Applying the matching concept should not result in the recognition of items in the statement of financial position (or balance sheet) that do not meet the definition of assets or liabilities.

Where economic benefits are expected to arise over several accounting periods, expenses are allocated to accounting periods in a systematic and rational way. For example, property, plant and equipment is depreciated in order to match the expense of acquiring it to the income which it generates. The expense is recognised in the accounting periods in which the economic benefits associated with it are consumed.

When expenditure produces no future economic benefits an expense should be recognised immediately in the income statement. An expense is also recognised when a liability is incurred without the recognition of an asset.

Question 6: Restoration costs

A mining company is legally obliged to restore the site and to rectify environmental damage after each mine is closed. Typically, a mine is expected to operate for at least twenty years. Approximately 40% of the eventual expense relates to the removal of mineshafts and the rectification of damage that occurs when the mine is originally sunk, the remainder of the cost relates to damage that is caused progressively as the minerals are extracted.

During the current reporting period the company has sunk a mineshaft but not yet commenced extracting minerals.

According to the Conceptual Framework, how should this event be reported in the financial statements for the current period and subsequent periods?

(The answer is at the end of the chapter)

4 The main financial statements

Section overview

- The principal financial statements of a business are the statement of financial position and the statement of comprehensive income.

4.1 Statement of financial position

Definition

The statement of financial position is simply a list of all the assets owned and/or controlled and all the liabilities owed by a business as at a particular date. It is a snapshot of the financial position of the business at a particular moment. Monetary amounts are attributed to each of the assets and liabilities.
4.1.1 Assets

Examples of assets are factories, office buildings, warehouses, delivery vans, lorries, plant and machinery, computer equipment, office furniture, cash and goods held in store awaiting sale to customers.

Some assets are held and used in operations for a long time. An office building is occupied by administrative staff for years; similarly, a machine has a productive life of many years before it wears out. These types of assets are called **non-current assets**.

Other assets are held for only a short time. The owner of a newspaper shop, for example, has to sell his newspapers on the same day that he gets them. The more quickly a business can sell the goods it has in store, the more profit it is likely to make; provided, of course, that the goods are sold at a higher price than what it cost the business to acquire them. These are **current assets**.

**Current/non-current distinction**

An entity must present **current** and **non-current** assets as separate classifications on the face of the statement of financial position. A presentation based on liquidity should only be used where it provides more relevant and reliable information, in which case all assets and liabilities must be presented broadly in order of liquidity.

It is emphasised how helpful information on the operating cycle is to users of financial statements. Where there is a clearly defined operating cycle within which the entity supplies goods or services, then information disclosing those net assets that are continuously circulating as **working capital** is useful.

This distinguishes them from those net assets used in the long-term operations of the entity. Assets that are expected to be realised and liabilities that are due for settlement within the operating cycle are therefore highlighted.

4.1.2 Liabilities

Examples of liabilities are amounts owed to a supplier for goods purchased on credit, amounts owed to a bank (or other lender), a bank overdraft and amounts owed to tax authorities (e.g. in respect of sales tax/GST).

Some liabilities are due to be repaid fairly quickly e.g. suppliers. Other liabilities may take some years to repay (e.g. a bank loan).

**Current/non-current distinction**

The categorisation of current liabilities is very similar to that of current assets. Therefore, some current liabilities are part of the **working capital** used in the normal operating cycle of the business (i.e. trade payables and accruals for employee and other operating costs). Such items will be classed as current liabilities even where they are due to be settled more than 12 months after the end of the reporting period. All other liabilities should be classified as non-current liabilities.

4.1.3 Capital or equity

The amounts invested in a business by the owner are amounts that the business owes to the owner. This is **capital**. In a limited liability company, capital usually takes the form of shares. Share capital is also known as **equity**.
4.1.4 Form of statement of financial position

A statement of financial position used to be called a balance sheet. The former name is apt because assets will always be equal to liabilities plus capital (or equity). An example of a statement of financial position for a company is shown below.

**XYZ – STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER**

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>450 850</td>
<td>470 790</td>
</tr>
<tr>
<td>Goodwill</td>
<td>80 800</td>
<td>91 200</td>
</tr>
<tr>
<td>Other intangible assets</td>
<td>227 470</td>
<td>227 470</td>
</tr>
<tr>
<td>Financial assets</td>
<td>142 500</td>
<td>156 000</td>
</tr>
<tr>
<td></td>
<td>901 620</td>
<td>945 460</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>135 230</td>
<td>132 500</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>91 600</td>
<td>110 800</td>
</tr>
<tr>
<td>Other current assets</td>
<td>25 650</td>
<td>12 540</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>312 400</td>
<td>322 900</td>
</tr>
<tr>
<td></td>
<td>564 880</td>
<td>578 740</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>1 466 500</td>
<td>1 524 200</td>
</tr>
<tr>
<td><strong>Equity and liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>650 000</td>
<td>600 000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>313 550</td>
<td>210 300</td>
</tr>
<tr>
<td>Other components of equity</td>
<td>10 200</td>
<td>21 200</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td>973 750</td>
<td>831 500</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term borrowings</td>
<td>120 000</td>
<td>160 000</td>
</tr>
<tr>
<td>Deferred tax</td>
<td>28 800</td>
<td>26 040</td>
</tr>
<tr>
<td>Long-term provisions</td>
<td>28 850</td>
<td>52 240</td>
</tr>
<tr>
<td><strong>Total non-current liabilities</strong></td>
<td>177 650</td>
<td>238 280</td>
</tr>
<tr>
<td>Current liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade and other payables</td>
<td>115 100</td>
<td>187 620</td>
</tr>
<tr>
<td>Short-term borrowings</td>
<td>150 000</td>
<td>200 000</td>
</tr>
<tr>
<td>Current portion of long-term borrowings</td>
<td>10 000</td>
<td>20 000</td>
</tr>
<tr>
<td>Current tax payable</td>
<td>35 000</td>
<td>42 000</td>
</tr>
<tr>
<td>Short-term provisions</td>
<td>5 000</td>
<td>4 800</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>315 100</td>
<td>454 420</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>492 750</td>
<td>692 700</td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
<td>1 466 500</td>
<td>1 524 200</td>
</tr>
</tbody>
</table>

**Case study: Statement of financial position**

The statement of financial position of Wesfarmers Limited at 30 June 2011 is shown below. This is presented in a different order from the illustration above, but notice that it still clearly shows the three elements defined in the Conceptual Framework and the relationship between them: ASSETS less LIABILITIES equals EQUITY.

Notice also that it clearly analyses assets and liabilities between current items and non-current items.
### Balance Sheet

**Wesfarmers Limited and its controlled entities**

**Balance Sheet**

**As at 30 June 2011**

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>CONSOLIDATED</th>
<th>2011 $m</th>
<th>2010 $m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets</strong></td>
<td>Note</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>8</td>
<td>897</td>
<td>1,640</td>
</tr>
<tr>
<td>Trade and other receivables</td>
<td>9</td>
<td>2,149</td>
<td>1,767</td>
</tr>
<tr>
<td>Inventories</td>
<td>10</td>
<td>4,857</td>
<td>4,659</td>
</tr>
<tr>
<td>Derivatives</td>
<td>27</td>
<td>184</td>
<td>75</td>
</tr>
<tr>
<td>Investments backing insurance contracts, reinsurance and other recoveries</td>
<td>11</td>
<td>1,543</td>
<td>1,384</td>
</tr>
<tr>
<td>Other</td>
<td>12</td>
<td>458</td>
<td>150</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td></td>
<td>10,218</td>
<td>9,674</td>
</tr>
<tr>
<td><strong>Non-current assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>9</td>
<td>9</td>
<td>28</td>
</tr>
<tr>
<td>Available-for-sale investments</td>
<td>13</td>
<td>17</td>
<td>19</td>
</tr>
<tr>
<td>Investment in associates</td>
<td>14</td>
<td>471</td>
<td>468</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>5</td>
<td>437</td>
<td>608</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>15</td>
<td>8,302</td>
<td>7,542</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>16</td>
<td>4,353</td>
<td>4,328</td>
</tr>
<tr>
<td>Goodwill</td>
<td>16</td>
<td>16,227</td>
<td>16,226</td>
</tr>
<tr>
<td>Derivatives</td>
<td>27</td>
<td>233</td>
<td>127</td>
</tr>
<tr>
<td>Investments backing insurance contracts, reinsurance and other recoveries</td>
<td>11</td>
<td>471</td>
<td>192</td>
</tr>
<tr>
<td>Other</td>
<td>17</td>
<td>76</td>
<td>44</td>
</tr>
<tr>
<td><strong>Total non-current assets</strong></td>
<td></td>
<td>30,596</td>
<td>29,562</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td></td>
<td>40,814</td>
<td>39,236</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th>CONSOLIDATED</th>
<th>2011 $m</th>
<th>2010 $m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current liabilities</strong></td>
<td>Note</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade and other payables</td>
<td>18</td>
<td>5,059</td>
<td>4,603</td>
</tr>
<tr>
<td>Interest-bearing loans and borrowings</td>
<td>19</td>
<td>256</td>
<td>304</td>
</tr>
<tr>
<td>Income tax payable</td>
<td></td>
<td>345</td>
<td>167</td>
</tr>
<tr>
<td>Provisions</td>
<td>20</td>
<td>1,166</td>
<td>1,176</td>
</tr>
<tr>
<td>Insurance liabilities</td>
<td>21</td>
<td>1,532</td>
<td>1,307</td>
</tr>
<tr>
<td>Derivatives</td>
<td>27</td>
<td>96</td>
<td>107</td>
</tr>
<tr>
<td>Other</td>
<td>22</td>
<td>256</td>
<td>198</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td></td>
<td>8,722</td>
<td>7,852</td>
</tr>
<tr>
<td><strong>Non-current liabilities</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payables</td>
<td>18</td>
<td>24</td>
<td>9</td>
</tr>
<tr>
<td>Interest-bearing loans and borrowings</td>
<td>19</td>
<td>4,813</td>
<td>5,049</td>
</tr>
<tr>
<td>Provisions</td>
<td>20</td>
<td>1,092</td>
<td>1,070</td>
</tr>
<tr>
<td>Insurance liabilities</td>
<td>21</td>
<td>803</td>
<td>403</td>
</tr>
<tr>
<td>Derivatives</td>
<td>27</td>
<td>208</td>
<td>138</td>
</tr>
<tr>
<td>Other</td>
<td>22</td>
<td>23</td>
<td>16</td>
</tr>
<tr>
<td><strong>Total non-current liabilities</strong></td>
<td></td>
<td>6,763</td>
<td>6,690</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td></td>
<td>15,485</td>
<td>14,542</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td></td>
<td>25,329</td>
<td>24,694</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EQUITY</th>
<th>CONSOLIDATED</th>
<th>2011 $m</th>
<th>2010 $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity attributable to equity holders of the parent</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued capital</td>
<td>23</td>
<td>23,286</td>
<td>23,286</td>
</tr>
<tr>
<td>Employee reserved shares</td>
<td>23</td>
<td>(41)</td>
<td>(51)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>24</td>
<td>1,774</td>
<td>1,414</td>
</tr>
<tr>
<td>Reserves</td>
<td>25</td>
<td>310</td>
<td>45</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td></td>
<td>25,329</td>
<td>24,694</td>
</tr>
</tbody>
</table>
4.2 Statement of comprehensive income

Definition

A statement of comprehensive income is a record of income generated and expenditure incurred over a given period. The statement shows whether the business has had more income than expenditure (a profit) or vice versa (loss).

4.2.1 Income and expenses

Income within the statement of comprehensive income is the income earned within a period. The expenses are the costs of running the business for the same period.

4.2.2 Form of statement of comprehensive income

The period chosen will depend on the purpose for which the statement is produced. The statement of comprehensive income which forms part of the published annual financial statements of a limited liability company will usually be for the period of a year, commencing from the date of the previous year’s statements. On the other hand, management might want to keep a closer eye on a company’s profitability by making up quarterly or monthly statements.

A statement of comprehensive income for a company is shown below.

XYZ – STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

<table>
<thead>
<tr>
<th></th>
<th>20X7</th>
<th>20X6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>415 000</td>
<td>375 000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(245 000)</td>
<td>(230 000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>170 000</td>
<td>145 000</td>
</tr>
<tr>
<td>Other income</td>
<td>17 767</td>
<td>16 400</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>(9 000)</td>
<td>(8 700)</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(20 000)</td>
<td>(21 000)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>(2 100)</td>
<td>(1 200)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(8 000)</td>
<td>(7 500)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>148 667</td>
<td>123 000</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(30 417)</td>
<td>(27 000)</td>
</tr>
<tr>
<td>Profit for the year from continuing operations</td>
<td>118 250</td>
<td>96 000</td>
</tr>
<tr>
<td>* Loss for the year from discontinued operations</td>
<td>–</td>
<td>(30 500)</td>
</tr>
<tr>
<td>Profit for the year</td>
<td>118 250</td>
<td>65 500</td>
</tr>
</tbody>
</table>

Other comprehensive income:

Remeasurement of financial assets | (14 000) | 20 000 |
Gains on property revaluation | 3 000 | 8 000 |
Other comprehensive income for the year | (11 000) | 28 000 |

Total comprehensive income for the year | 107 250 | 93 500 |

Case study: Statement of comprehensive income

The statement of comprehensive income (income statement) of Wesfarmers Limited for the year ended 30 June 2011 is shown below. Wesfarmers presents two separate statements of financial performance: the income statement (showing the components of profit or loss for the year) and the statement of comprehensive income (showing profit for the year together with gains and losses that are not recognised in profit or loss). Note: The statement of comprehensive income is not shown here.

Notice that Wesfarmers analyses items of income and expenses according to their nature. The illustration above analyses expenses by their function. But the statement still clearly shows the two elements: income and expenses.
4.3 Purpose of financial statements

Both the statement of financial position and the statement of comprehensive income are summaries of accumulated data. For example, the statement of comprehensive income shows a figure for revenue earned from selling goods to customers. This is the total amount of revenue earned from all the individual sales made during the period. One of the jobs of an accountant is to devise methods of recording such individual transactions, so as to produce summarised financial statements from them.

The statement of financial position and the statement of comprehensive income form the basis of the financial statements of most businesses. For limited liability companies, other information by way of statements and notes may be required by national legislation and/or accounting standards, for example a statement of cash flows and a statement of changes in equity. We look at the second of these below.

4.4 Statement of changes in equity

The statement of changes in equity shows the movements in the various components of equity (share capital, retained earnings and other reserves) for a period. The purpose of the statement is to show the transactions between the company and its owners. These consist of:

- total comprehensive income for the year, made up of the profit or loss for the year (changes in retained earnings), plus other comprehensive income (items such as revaluation gains which are not included in profit or loss, but recognised in a separate reserve within equity)
- contributions from owners: issues of shares
- distributions to owners: dividends paid.

An example of a simple statement of changes in equity is shown below.
XYZ – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

<table>
<thead>
<tr>
<th>Share capital</th>
<th>Retained earnings</th>
<th>Other components</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$’000</td>
<td>$’000</td>
<td>$’000</td>
<td>$’000</td>
</tr>
<tr>
<td><strong>Balance at 1 Jan 20X7</strong></td>
<td>600 000</td>
<td>210 300</td>
<td>21 200</td>
</tr>
<tr>
<td><strong>Changes in equity for 20X7</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issue of share capital</td>
<td>50 000</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Dividends</td>
<td>–</td>
<td>(15 000)</td>
<td>–</td>
</tr>
<tr>
<td>Total comprehensive income for the year</td>
<td>–</td>
<td>118 250</td>
<td>(11 000)</td>
</tr>
<tr>
<td><strong>Balance at 31 Dec 20X7</strong></td>
<td>650 000</td>
<td>313 550</td>
<td>10 200</td>
</tr>
</tbody>
</table>

**Question 7: Accounting information**

The financial statements of a limited liability company will consist solely of the statement of financial position and statement of comprehensive income.

Is this statement correct?

A  true  
B  false

(The answer is at the end of the chapter)
Key chapter points

- Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.

- Financial position is shown by:
  - Assets
  - Liabilities
  - Equity.

- Financial performance is shown by:
  - Income
  - Expenses.

- Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain recognition criteria:
  - It is probable that any future economic benefit associated with the item will flow to or from the entity, and
  - The item has a cost or value that can be measured reliably.

- The principal financial statements of a business are the statement of financial position and the statement of comprehensive income.
Quick revision questions

1. Of what is the following statement a definition?

'A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.'

A. equity  
B. liability  
C. asset  
D. expense

2. Which of the following is the correct definition of a liability?

A. the residual interest in the assets of the entity after deducting all its liabilities  
B. a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits  
C. a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity  
D. a present obligation arising from past events from which future economic benefits are expected to flow to the entity

3. What are the criteria for recognition of items in the financial statements according to the IASB's Conceptual Framework?

A. probable that future economic benefit will flow to or from the entity  
B. probable that future economic benefit will flow to or from the entity and the item can be measured with reliability  
C. probable that there will be outflow of future economic benefits and there is a past transaction  
D. probable that there will be an inflow or outflow of future economic benefits and there is a past transaction

4. What items are recognised in the statement of comprehensive income?

I. Assets  
II. Liabilities  
III. Income  
IV. Expenses  
V. Equity  
A. III only  
B. III and IV only  
C. IV and V only  
D. I, II, III, IV and V

5. Which of the following is an example of a current asset?

A. property, plant and equipment  
B. motor vehicles held for sale  
C. manufacturing licences  
D. retained earnings
6 Which of the following items are non-current assets?
   I Land
   II Machinery
   III Bank loan
   IV Inventory
A I only
B I and II only
C I, II and III only
D II, III and IV only

7 How is a bank overdraft classified in the statement of financial position?
A non-current asset
B current asset
C current liability
D non-current liability

8 How should the balance on the payables account be reported in the final accounts?
A as an expense
B as a current asset
C as a current liability
D as a non-current asset

9 Which of the following is an example of a liability?
A inventory
B receivables
C plant and machinery
D loan

10 What determines whether an asset should be shown as a current asset in the statement of financial position?
A whether it is part of the operating cycle of the entity and this provides more relevant and reliable information
B whether it is used on a long term basis in the business
Answers to quick revision questions

1. C  This is the definition of an asset contained within the Conceptual Framework and various IFRS.
2. B  This is the definition of a liability contained within the Conceptual Framework and various IFRS.
     A is the definition of equity; C is the definition of an asset; D is a mixture of the definitions of a liability and an asset.
3. B  There are two elements to the recognition criteria: a probable flow of economic benefits and reliable measurement. The ‘past event’ criteria forms part of the definitions of an asset and liability and is not repeated within the recognition criteria.
4. B  Assets, liability and equity are included in the statement of financial position.
5. B  Motor vehicles are generally a non-current asset, however motor vehicles held for sale are current assets in accordance with IFRS. Property, plant and equipment and licenses are non-current assets of a business; retained earnings are part of the equity in a business.
6. B  A bank loan is a liability of a business and inventory is a current asset.
7. C  An overdraft is classed as current, even where there is a rolling facility, as it is repayable on demand.
8. C  Payable accounts are part of the normal operating cycle of a business, and as such are classified as current liabilities, even where the credit period exceeds 12 months.
9. D  A, B and C are all assets.
10. A  IAS 1 requires that assets are classified as current where they are expected to be realised in an entity’s normal operating cycle, are held primarily for trading, are cash or a cash equivalent or are expected to be realised within 12 months of the reporting date.
Answers to chapter questions

1 (a) This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost savings).

(b) This cannot be classified as an asset. Baldwin Co has no control over the car repair shop and it is difficult to argue that there are ‘future economic benefits’.

(c) The warranty claims in total constitute a liability; the business has taken on an obligation. It would be recognised when the warranty is issued rather than when a claim is made.

2 The accounting policies apply the definitions and the recognition criteria in the Conceptual Framework for Financial Reporting (as well as the requirements of IAS 38 Intangible assets).

Although expenditure on research activities may eventually result in future economic benefits (and therefore there may be an asset) it cannot be capitalised because it does not meet the recognition criteria: it is too early to say whether there will actually be any economic benefit or to be able to make any kind of reliable estimate of the amount.

In contrast, development expenditure is capitalised if it meets certain criteria. There is an asset: the new product and the ideas behind it are controlled by the entity and there is expected to be an inflow of economic benefit in the form of increased revenue or reduced costs. An intangible asset is recognised if the product or process is technically and commercially feasible and there are sufficient resources to complete development. If these criteria are met the inflow of economic benefit is probable. The second criteria of reliable measurement is also met because the amount to be capitalised is the cost of materials, labour and a proportion of overheads; these amounts will be recorded in the company’s accounting system.

If development expenditure does not meet the criteria it is not recognised as an asset, but as an expense in the period in which it is incurred.

3 Because there is only a 40% chance of the claim succeeding it is (a) not clear whether the company has a liability and (b) even if there is a liability it fails to meet the recognition criteria (it is only possible, not probable, that the entity will be found liable and that there will be an outflow of economic benefits in the form of damages paid).

This is a contingent liability (as defined by IAS 37 Provisions, contingent liabilities and contingent assets, para 10): a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of an uncertain future event not wholly within the control of the entity or a present obligation that is not recognised because it is not probable that an outflow of economic benefits will be required in settlement.

The company should not recognise a liability (a provision). Instead, it should disclose the possible liability in the notes to the financial statements.

4 The preference shares are a non-current liability and should not be presented as part of equity in the statement of financial position. They have the characteristics of a loan, rather than an owners’ interest. A liability exists because the company has an obligation to pay interest over the life of the ‘shares’ and eventually to repay the principal amount.

5 In order for an entity to recognise revenue, there must be an increase in its net assets. Customers pay for airline tickets before they actually receive the service that they have paid for. The terms of airline tickets vary. In some cases the passenger can only fly on the date and to the destination originally booked, but in other cases tickets may be exchangeable, transferable or refundable or they may be valid for travel during a particular period, rather than on a specific flight.

The Qantas Group does not recognise revenue until passengers actually travel, ie, when it actually delivers the service that has been paid for. Depending on the terms of the ticket, until that time the company probably has a liability in the form of an obligation to make a refund to the customer or to offer another flight. When the customer actually travels, the liability is discharged. The recognition conditions are met: there is a decrease in a liability, and a certain inflow of economic benefit which can be reliably measured.
Unused tickets can be recognised as revenue in certain conditions. For example, where a customer books a ticket that only permits travel on a specific flight and then fails to travel, the company still receives the cash paid for the ticket (an inflow of economic benefit that meets both recognition conditions) but has no obligation to provide another flight.

6 **In the current period**

At the year-end the company has a legal obligation to restore the site as a result of a past event (sinking the mineshaft). It will eventually have to incur expenditure (an outflow of economic benefit). Therefore it has a liability which meets both the recognition criteria:

(a) the outflow of economic benefit is probable, even though it may not occur for many years; and

(b) the amount can be reliably estimated (on the basis of the amount it would cost to restore the site at the year-end, adjusted as necessary for expected future changes in technology etc).

The company should recognise a liability, but only for the expenditure relating to the sinking of the mineshaft (and the damage that has actually occurred at the year-end).

The company cannot extract the minerals without eventually incurring the expenditure of restoring the site. The restoration costs also meet the definition of an asset (the expenditure will generate future economic benefits in the form of sales revenue) and also meet the recognition criteria: an inflow of economic benefit is probable and the cost of restoration can be reliably estimated.

Therefore in the current period there is no change in the company’s net assets and no expenditure is recognised.

**In subsequent periods**

The restoration cost asset will also be ‘consumed’ as it generates revenue over the useful life of the mine. Therefore the company will recognise an increasing expense for depreciation in each period until the mine is decommissioned.

7 **B** A complete set of financial statements for a limited company (reporting entity) normally includes:

- a statement of the entity’s financial position
- a statement or statements showing the entity’s financial performance
- a statement showing changes in the entity’s financial position (usually a statement of cash flows)
- notes to the financial statements and other supplementary information.
Learning objectives

<table>
<thead>
<tr>
<th>Alternative methods of valuation</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identify and explain the advantages and disadvantages of the historical cost system of accounting</td>
<td>LO6.1</td>
</tr>
<tr>
<td>Identify, explain and calculate amounts using the following measurement bases:</td>
<td>LO6.2</td>
</tr>
<tr>
<td>historical cost</td>
<td>LO6.2.1</td>
</tr>
<tr>
<td>fair value</td>
<td>LO6.2.2</td>
</tr>
<tr>
<td>deprival value</td>
<td>LO6.2.3</td>
</tr>
<tr>
<td>replacement cost</td>
<td>LO6.2.4</td>
</tr>
<tr>
<td>net realisable value</td>
<td>LO6.2.5</td>
</tr>
</tbody>
</table>

Topic list

1. Historical cost accounting
2. Measurement of the elements of financial statements
This chapter considers the use of the historical cost concept in the preparation of financial statements and its advantages and disadvantages. Following on from that, we look at different measurement bases that can be used in financial statements including fair value, deprival value, replacement cost and net realisable value.

**Introduction**

**Historical cost accounting**
- Assets are recorded at the amounts paid / received at acquisition

**Problems:**
- inflation
- increases in asset values are not reflected in financial statements

**Advantages:**
- objective method
- costs can easily be verified

**Measurement of the elements of financial statements**
Measurement options other than historical cost include:
- Replacement cost / current value
- Net realisable value
- Deprival value
- Fair value

If historical cost is used, depreciation charge is usually insufficient and holding gains included in profit if prices are rising.
Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

1 Explain the historical cost basis of measurement. (Section 1.1)
2 What are the problems of the historical cost basis of measurement? (Sections 1.2 and 2.6)
3 Which of the following are examples of deprival value? (Section 2.3)
   I Net realisable value
   II Replacement cost
   III Historical cost
   IV Economic value
   V Fair value
   A I and IV
   B II, III and V
   C I, II and IV
   D II and IV
4 What is the definition of fair value? (Section 2.4)
1 Historical cost accounting

1.1 Introduction

Accounting concepts are part of the theoretical framework on which accounting practice is based. It is worth looking at one further general point: the problem of attributing monetary values to the items which appear in accounts.

A basic principle of accounting (some writers include it in the list of fundamental accounting concepts) is that transactions are normally stated in accounts at their historical amount.

Measurement is defined below.

Definitions

Measurement. The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of comprehensive income. (Conceptual Framework)

This involves the selection of a particular basis of measurement. A number of these are used to different degrees and in varying combinations in financial statements. The Conceptual Framework provides the following definitions:

Definitions

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

Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realisable (settlement) value.

- Realisable value. The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.
- Settlement value. The undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Present value. A current estimate of the present discounted value of the future net cash flows in the normal course of business. (Conceptual Framework)

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, e.g. inventory is carried at the lower of cost and net realisable value, marketable securities and non-current assets may be carried at market value (or fair value) and pension liabilities are carried at their present value.

During the 1970s and 1980s some entities used current cost as a way of dealing with the effects of high rates of inflation. However, at the present time current cost is used very rarely.

The Conceptual Framework does not discuss fair value, although many IFRS allow or require its use.
1.2 Historical cost

Definition

The historical cost convention has a number of implications:

- Transactions are stated at their value when they occurred. This means, for example, that the cost of goods sold is not suddenly increased at the end of the year.
- Assets are stated at their historical cost. In other words, the value of an asset in a statement of financial position is based on the price that was paid for it.

An important advantage of this convention is that there is usually objective, documentary evidence to prove the purchase price of an asset, or amounts paid as expenses.

In general, accountants prefer to deal with objective costs, rather than with estimated values. This is because valuations tend to be subjective and to vary according to the purpose of the valuation. There are some problems with the principle of historical cost which include the following:

(a) The wearing out of assets over time.
(b) The increase in market value of property.
(c) Inflation.

You may be able to think of other problems.

1.3 Problems with historical cost

Example: Problems with historical cost

Suppose that a partnership buys a machine to use in its business. The machine has an expected useful life of four years. At the end of two years the partnership is preparing a statement of financial position and has to decide what monetary amount to attribute to the asset. Numerous possibilities might be considered:

- The original cost (historical cost) of the machine.
- Half of the historical cost, on the basis that half of its useful life has expired.
- The amount the machine might fetch on the second-hand market.
- The amount it would cost to replace the machine with an identical machine.
- The amount it would cost to replace the machine with a more modern machine incorporating the technological advances of the previous two years.
- The machine’s economic value, i.e. the amount of the profits it is expected to generate for the partnership during its remaining life.

All of these valuations have something to recommend them, but the great advantage of the first two is that they are based on a figure (the machine’s historical cost) which is objectively verifiable.

Question 1: Festivals

You are in business in a small town, whose main source of economic prosperity is the tourist trade. On 25 March 20X2 the town celebrated the 1000th anniversary of its existence. The town held a number of festivals to mark this occasion and to bring in more tourists.

Your business has had the good fortune to be involved in the event. You have made 1000 commemorative mugs. These were all made by 31 December 20X1 to be ready at the beginning of the year. They cost 40 cents each to make and during the anniversary year they were for sale at 75 cents each. At the end of the anniversary year, there are 200 still unsold. You estimate that you are unlikely to sell any more at 75 cents, but you might be able to sell them at 30 cents each.
Required

Explain how you would assess the value of the mugs in your statements of financial position:

(a) at the end of 20X1;
(b) at the end of 20X2.

On the basis of your considerations, note down the value of the mugs you would include in the statements of financial position at 31 December 20X1 and 31 December 20X2.

(The answer is at the end of the chapter)

2 Measurement of the elements of financial statements

2.1 Replacement cost

Definition

Replacement cost means the amount needed to replace an item with an identical item. This is the same as current cost.

Example: Replacement cost

XY Co purchased a machine five years ago for $15,000. It is now worn out and needs replacing. An identical machine can be purchased for $20,000.

Historical cost is $15,000
Replacement cost is $20,000

2.2 Net realisable value

Definition

Net realisable value is the expected price less any costs still to be incurred in getting the item ready for sale and then selling it.

Example: Net realisable value

XY Co’s machine from the example above can be restored to working order at a cost of $5,000. It can then be sold for $10,000. What is its net realisable value?

Net realisable value = $10,000 − $5,000
= $5,000

2.3 Deprival value

Definition

Deprival value is the loss which a business entity would suffer if it were deprived of the use of the asset.
Alternative methods of valuation

**Value to the business**, or deprival value, can be any of the following values:

(a) **Replacement cost**: in the case of non-current assets, it is assumed that the replacement cost of an asset would be its net replacement cost (NRC), its gross replacement cost minus an appropriate provision for depreciation to reflect the amount of its life already ‘used up’.

(b) **Net realisable value** (NRV): what the asset could be sold for, net of any disposal costs.

(c) **Economic value** (EV), or value in use: what the existing asset will be worth to the company over the rest of its useful life.

The deprival value is the lower of replacement cost and recoverable amount. In turn the recoverable amount is the higher of net realisable value and economic value.

Deprival value, or value to the business, is supposed to reflect economic reality or management’s intentions. Where there is a choice between selling an asset and continuing to use it, it is assumed that business will always take the course of action that will maximise the resulting inflow of economic benefit.

**Example: Economic value**

Suppose XY Co purchases a new machine for $20 000. It is estimated that the new machine will generate profits of $4 000 per year for its useful life of eight years. What is its economic value?

\[
\text{Economic value} = 4 000 \times 8 = 32 000
\]

The topic of deprival value will be covered in more detail in Chapter 7.

**Question 2: Deprival value**

On 1 January 20X1 a company bought plant costing $50 000. Its useful life was estimated to be ten years and it had no residual value.

At 31 December 20X3 it was estimated that the plant could be sold for $20 000 but it would have to be dismantled, which would cost approximately $2 000.

If the company continues to use the machine, management estimates that it will generate net cash inflows with a present (discounted) value of $25 000.

New plant of the same type would cost $60 000 at 31 December 20X3.

Calculate the deprival value of the asset. Explain why this amount is its value to the business.

(The answer is at the end of the chapter)

### 2.4 Fair value

**Definition**

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

Fair value is the amount an asset could be sold or a liability discharged in an arm’s length transaction. Fair value is the market value of an item in a hypothetical transaction. In IFRS it is normally taken to be open market value, or ‘exit value’, from the seller’s perspective.

Fair value is appropriate where there is an active market for the asset being valued. But where there is no active market, substitutes or estimates have to be used and then the resulting valuation may not fairly represent the resource available.
Question 3: Deprival value and fair value

A company has two properties.

I   An office building that it is holding for its investment potential, rather than for its use in the business.
II  A specialised property: a school building.

For which of these properties is deprival value likely to be approximately the same as fair value?

A I only
B II only
C both properties
D neither property

(The answer is at the end of the chapter)

2.5 Advantages of historical cost accounting

Historical cost accounting has several important advantages.

- It is **objective**. Cost is known and can be proved (e.g. by the invoice). If fair values or other forms of current value are used, these are necessarily subjective.
- It is **easily understood** by users. Profit is the amount by which selling price exceeds the (depreciated) original cost of the item sold or service provided.
- It is **easy to apply**. In contrast, most of the alternatives (deprival value, current cost and even fair value) can be difficult and time consuming to estimate or calculate. For example, arriving at deprival value may involve estimating future cash flows for a number of years and then discounting them to present value.
- It **provides useful information** to users. Users need reliable and faithfully represented information about past transactions in order to predict an entity’s future performance. Information about the current or fair value of assets may be useful to large institutional investors in listed companies, but is largely irrelevant for others.
- It is **prudent**. Until fairly recently, prudence (conservatism) was recognised as a fundamental accounting concept. Revenue and profits are not anticipated, but included in profit or loss only when it is reasonably certain that they will be realised in the form of cash or other assets. Where there is uncertainty, measuring non-current assets at historical cost is a cautious approach.
- It has **stood the test of time**. Some theorists argue that historical cost is worth retaining because it has been developed by trial and error by business owners and managers over several years. In contrast, systems of current cost accounting and fair value accounting are based on academic theories and have never really been proved to work in practice.
- If (for example) the current market prices of property or investments are very different from their historical cost, this information **can be disclosed** in the notes to the financial statements. There is no need to adjust the amounts in the statement of financial position or the other primary statements.

Defenders of historical cost accounting argue that, although historical cost has shortcomings, there is no real evidence that current costs or fair values provide more useful information. Some advantages of historical cost accounting follow from the disadvantages of current value or fair value accounting:

- Use of fair values and current values **can encourage management to manipulate the amounts** in the financial statements, because current value can only be an estimate. Accounting standards and other forms of regulation can provide some protection against this, by, for example, requiring regular revaluations by qualified external valuers, but there will always be some scope for ‘creative accounting’.
- Current value accounting **anticipates profits that may never be realised**. Market prices may fall or the asset may be damaged before it can be sold. Alternatively, the entity may have no intention of selling the asset in the foreseeable future (for example, because it uses it in its operations).
Because market values can fluctuate, using fair value can cause volatility in the financial statements. IFRS require gains and losses on revaluation of investment property and some financial instruments to be recognised directly in profit or loss. When reported results fluctuate unexpectedly it can be difficult for users to make a fair assessment of an entity’s performance and to understand underlying trends. Some believe this volatility is acceptable because it reflects economic reality. However, unexpected losses can also have serious economic consequences; many believe that the use of fair values contributed to the global economic crisis in 2008.

**Question 4: Objectivity**

The main arguments in favour of historical cost accounting are that it is objective and that users generally find it easier to understand than the alternatives, such as fair value.

Briefly explain why this may not always be the case.

*(The answer is at the end of the chapter)*

---

### 2.6 Disadvantages of historical cost accounting

There are a number of disadvantages of historical cost accounting. Many of these arise in particular in times of rising prices (inflation). When inflation is low, historical cost accounting is usually satisfactory. However, when inflation is high the following problems can occur. Other disadvantages have arisen as business practice and transactions have become more complex.

#### 2.6.1 Non-current asset values are unrealistic

The most striking example is property. Although some entities have periodically updated the statement of financial position values, in general there has been a lack of consistency in the approach adopted and a lack of clarity in the way in which the effects of these changes in value have been expressed.

If non-current assets are retained in the books at their historical cost, **unrealised holding gains are not recognised**. This means that the total holding gain, if any, will be brought into account during the year in which the asset is realised, rather than spread over the period during which it was owned. In contrast, unrealised holding losses are recognised in the form of impairment of assets.

There are, in essence, two contradictory points to be considered:

(a) Although it has long been accepted that a statement of financial position prepared under the historical cost concept is an historical record and not a statement of current worth, many people now argue that the statement of financial position should at least give an indication of the **current value** of the company’s tangible net assets.

(b) Traditionally, generally accepted accounting practice has required that profits should only be recognised when realised in the form of either cash or other assets, the ultimate cash realisation of which can be assessed with reasonable certainty (prudence or conservatism). It may be argued that recognising unrealised holding gains on non-current assets is contrary to this convention.

On balance, the weight of opinion held generally by the IASB and specifically by Australia and the UK is now in favour of restating asset values. It is felt that the criticism based on prudence can be met by ensuring that valuations are made as objectively as possible (e.g. in the case of property, by having independent expert valuations) and by not taking unrealised gains through profit or loss, but instead through reserves.

#### 2.6.2 Depreciation is inadequate to finance the replacement of non-current assets

Depreciation is not provided for in order to enforce retention of profits and therefore ensure that funds are available for asset replacement. It is intended as a measure of the contribution of non-current assets to an entity’s activities in the period. However, an incidental effect of providing for depreciation is that not all liquid funds can be paid out to investors thus enabling funds for asset replacement to remain on hand. What is important is not the replacement of one asset by an identical new one (something that rarely happens) but the replacement of the **operating capability** represented by the old asset.
2.6.3 Holding gains on inventories are included in profit

Another criticism of historical cost accounting is that it does not fully reflect the value of the asset consumed during the accounting year.

During a period of high inflation the monetary value of inventories held may increase significantly while they are being processed. The conventions of historical cost accounting lead to the unrealised part of this holding gain (known as inventory appreciation) being included in profit for the year.

The following simple example is given to help your understanding of this difficult concept.

Example: Holding gain

At the beginning of the year a company has 100 units of inventory and no other assets. Its trading account for the year is shown below.

<table>
<thead>
<tr>
<th>TRADING ACCOUNT</th>
<th>Units</th>
<th>$</th>
<th>Units</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening inventory</td>
<td>100</td>
<td>200</td>
<td>Sales (made 31 December)</td>
<td>100</td>
</tr>
<tr>
<td>Purchases (made 31 December)</td>
<td>100</td>
<td>400</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>200</td>
<td>600</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing inventory (FIFO basis)</td>
<td>100</td>
<td>400</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>100</td>
<td>200 (COGS)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross profit</td>
<td>–</td>
<td>300</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>100</td>
<td>500 (Sales)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Apparently the company has made a gross profit of $300. But, at the beginning of the year the company owned 100 units of inventory and at the end of the year it owned 100 units of inventory and $100 cash (sales $500 less purchases $400). From this it would seem that a profit of $100 is more reasonable. The remaining $200 is inventory appreciation arising because the purchase price increased from $2 to $4.

The criticism can be overcome by using a capital maintenance concept based on physical units rather than money values (see Chapter 7).

2.6.4 Profits (or losses) on holdings of net monetary items are not shown

In periods of inflation the purchasing power, and therefore the value, of money falls. It follows that an investment in money will have a lower real value at the end of a period of time than it did at the beginning. A loss has been incurred. Similarly, the real value of a monetary liability will reduce over a period of time and a gain will be made.

2.6.5 The true effect of inflation on capital maintenance is not shown

To a large extent this follows from the points already mentioned. It is a widely held principle that distributable profits should only be recognised after full allowance has been made for any erosion in the capital value of a business. In historical cost accounts, although capital is maintained in nominal money terms, it may not be in real terms. So, profits may be distributed to the detriment of the long-term viability of the business. This criticism may be made by those who advocate capital maintenance in physical terms.

2.6.6 Comparisons over time are unrealistic

This will tend to an exaggeration of growth. For example, if a company’s profit in 1979 was $100 000 and in 2009 $500 000, a shareholder’s initial reaction might be that the company had done rather well. If, however, it was then revealed that with $100 000 in 1979 he could buy exactly the same goods as with $500 000 in 2009, the apparent growth would seem less impressive.

2.6.7 Historical cost no longer reflects economic reality

The arguments against historical cost accounting set out above mainly relate to its conceptual shortcomings. More recently criticisms of historical cost have focused on its failure to capture important information about particular types of transaction or event. There are two main issues:

(a) Historical cost does not record any transaction that does not have a monetary impact. This is particularly important where an entity holds certain types of financial instruments, such as
derivatives. A derivative is a financial instrument whose value changes in response to the change in a specified interest rate, commodity price, foreign exchange rate or other variable. Derivatives can be acquired for very little or no cost, but can expose an entity to very significant uncertainty and risk (potential for gain or loss) and this can have a very material effect on its financial performance, financial position and cash flows. During the 1990s there were a number of high profile accounting scandals and company failures involving derivatives. Because a derivative contract normally has little or no initial cost, under traditional accounting it may not be recognised in the financial statements at all. Alternatively it may be recognised at an amount which bears no relation to its current value. This is clearly misleading and leaves users of the financial statements unaware of the level of risk that the company faces. Current standards require derivatives to be measured at fair value.

(b) Historical cost provided relevant information when the main purpose of financial statements was to enable owners to assess the stewardship of management. The emphasis is now on the financial statements as a means of providing information to investors, lenders and other creditors and their advisors to help them to make ‘hold or sell’ and similar decisions. Many believe that fair value provides these users with more relevant information than historical cost because:

- Fair values have more predictive value.
- Some assets are traded on an active market or held for their investment potential (rather than being held to be used in the business).
- Fair value often reflects the way risks are managed (for financial instruments).
- For assets such as property, fair value provides information on the resources actually available to an entity.

The Conceptual Framework explains that users need information to help them assess the prospects for future net cash inflows to an entity; this is unlikely to be provided by historical cost information alone.

The points mentioned above have demonstrated some of the accounting problems associated with historical cost accounting, particularly in times of severe and prolonged inflation. So far, we have considered possible alternative measurement bases, such as fair value, but there are also alternative systems of accounting.

Of the various possible systems of accounting for price changes, most fall into one of three categories as follows:

(a) General price change bases and in particular, current purchasing power (CPP).

(b) Current value bases. The basic principles of all these are:

(i) To show statement of financial position items at some form of current value rather than historical cost.
(ii) To compute profits by matching the current value of costs at the date of consumption against revenue.

The current value of an item will normally be based on replacement cost, net realisable value or economic value.

(c) A combination of these two systems: suggestions of this type have been put forward by many writers.

2.7 Why modified historical cost accounting is still used

It must seem strange, given the criticisms levelled at it, that modified historical cost accounting is still in such widespread use. There are various reasons for this, not the least of which is resistance to change in the conservative accounting profession.

Many entities prepare modified historical cost accounts: some assets (normally non-current tangible assets and financial instruments) are measured at fair value or current value/deprival value while the remainder continue to be measured at historical cost. Modified historical cost accounts are easy to prepare, easy to read and easy to understand. While such accounts do not reflect current values, the
revaluation of non-current assets improves the value of them enormously. IFRS encourages the use of fair value, although entities can choose to measure non-financial assets, including investment property, at depreciated historical cost.

In addition, as we have seen, alternatives such as fair value and deprival value also have disadvantages. Some argue that no single alternative measurement base can fairly represent the economic substance of all transactions.

In periods of low inflation, historical cost accounts are viewed as a reasonable reflection of the reality of the given situation.

The alternatives to historical cost accounting are considered further in Chapter 7.
A basic principle of accounting (some writers include it in the list of fundamental accounting concepts) is that transactions are normally stated in accounts at their historical amount.

There are a variety of other possible methods of measurement:
- Fair value
- Deprival value
- Replacement cost
- Net realisable value.

The main advantage of historical cost accounting is that the cost is known and can be proved. In addition, there is no subjectivity or bias in the valuation. There are also a number of disadvantages and these usually arise in times of rising prices (inflation). Other disadvantages have arisen as business practice and transactions have become more complex.
Quick revision questions

1. Which statement is true of the historical cost convention?
   A. it fails to take account of changing price levels over time
   B. it records only past transactions
   C. it values all assets at their cost to the business, without any adjustment for depreciation
   D. it has been replaced in accounting records by a system of current cost accounting

2. Valuation (or measurement) is the process of determining the monetary amounts at which items are included in the financial statements. Which of the following is a basis of valuation?
   A. business entity
   B. money measurement
   C. historical cost
   D. going concern

3. What is the accounting convention which, in times of rising prices, tends to understate asset values and overstate profits?
   A. going concern concept
   B. prudence concept
   C. historical cost
   D. deprival value

4. Under what basis are assets usually valued?
   A. replacement cost
   B. historical cost
   C. net realisable value
   D. deprival value

5. In times of rising prices, what effect does the use of the historical cost concept have on a company’s asset values and profit?
   A. asset values and profit both understated
   B. asset values and profit both overstated
   C. asset values understated and profit overstated
   D. asset values overstated and profit understated

6. Korbin Co buys a machine for $50 000. It will generate income of $8 000 per annum for seven years. What is its economic value?
   A. $50 000
   B. $8 000
   C. $56 000
   D. $42 000

7. Ladybird Co is considering scrapping a machine for proceeds of $1 000. Alternatively, it can spend $800 on the machine and receive sales proceeds of $1 900. What is the net realisable value of the machine?
   A. $1 100
   B. $1 900
   C. $1 000
   D. $200

8. Which of the following is not an advantage of measuring certain assets at fair value?
   A. it has predictive value
   B. it is only relevant where there is an active market for an asset
   C. it provides information about the resources available to an entity
   D. it reflects the economic reality of transactions involving derivative financial instruments
Answers to quick revision questions

1. A  Under the historical cost convention, assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.

2. C  Historical cost is the only measurement basis listed: business entity is concerned with the separation of a business from its owner; money measurement requires that every transaction is measured in terms of money; going concern is the assumption that a business will continue to trade for the foreseeable future.

3. C  If non-current assets are retained in the books at their historical cost, unrealised holding gains are not recognised, so resulting in the understatement of assets. Similarly profits are overstated because many costs, such as opening inventory, are historic and recorded at out of date prices compared to revenue which is recorded at more recent prices.

4. B  Historical cost is the measurement basis most widely applied in financial statements.

5. C  Assets will tend to be understated and profits overstated due to low depreciation charges.

6. C  $8,000 \times 7 \text{ years} = $56,000

7. A  Proceeds $1,900 less costs to sell of $800 = $1,100

8. B  It can be difficult to arrive at a reliable estimate of fair value where there is not an active market for a particular asset.
1 The accruals concept states that income and expenditure should be matched in the same period if reasonably possible. It is also generally accepted that revenue should not be anticipated. However, you are reasonably certain of selling the mugs, so you would value them in the statement of financial position at the beginning of the year at cost, as an asset (rather than treating them as an expense in the income statement for that earlier year).

At 31 December 20X2 you have 200 spare, whose selling price is less than the cost of making them. Generally accepted accounting practice (IAS 2) is that inventories are valued in the statement of financial position at the lower of these two amounts (i.e. sales value if it is lower than cost).

You could argue that valuing them at a lower amount means a conflict with the accruals concept, because the loss is accounted for before the sale. This is true. However, the loss is certain to occur, and this should be reflected in the accounts.

As a consequence, at 31 December 20X1, the mugs would be valued at 40 cents each. At 31 December 20X2, the remaining mugs would be valued at 30 cents each.

2 Deprival value is calculated as the lower of replacement cost and recoverable amount. Recoverable amount is the higher of economic value (value in use) and net realisable value.

Net realisable value is $18 000 (20 000 – 2 000).

Economic value is $25 000.

Net (depreciated) replacement cost is $42 000 (60 000 × 7/10).

Recoverable amount is $25 000 (economic value).

Deprival value is $25 000 (economic value).

This is the value of the plant to the business because:

- the company can generate more cash from continuing to use the plant than from selling it (economic value is higher than net realisable amount);
- however, the company will not replace the plant, because this would cost more than it could obtain from continuing to use it in the business.

3 The answer is A

For Property I, the investment property, deprival value will almost certainly be net realisable value, which will be roughly the same as fair value (open market value).

For Property II, deprival value will probably be depreciated replacement cost. This is likely to be higher than net realisable value/open market value (fair value) because a specialised property is often difficult to sell (the buyer may have to make substantial alterations to it before it can be used).

4 Historical cost accounting makes extensive use of subjective estimates, for example, useful lives of assets, allowances for doubtful receivables and inventory valuation.

It can be argued that some users are confused by historical cost accounts. Non-accountants may believe that the statement of financial position shows the actual value of an entity’s assets and liabilities, rather than their cost.
Chapter 7

Alternative theories of accounting

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<td><strong>Alternative theories of accounting</strong></td>
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</tr>
<tr>
<td>Define positive accounting theory</td>
<td>LO7.1</td>
</tr>
<tr>
<td>Define normative accounting theory</td>
<td>LO7.2</td>
</tr>
<tr>
<td>Identify financial capital maintenance and operating capital maintenance and how this can affect calculated profits</td>
<td>LO7.3</td>
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<tr>
<td>Describe operating and financial capital maintenance as alternatives to historical cost and identify the impact on reported profits</td>
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**Topic list**

1. Positive and normative accounting theory
2. Alternatives to historical cost
3. Concepts of capital and capital maintenance
4. Current purchasing power (CPP)
5. Current cost accounting (CCA)
In this chapter we look at the alternatives to historical cost accounting.

**Positive and normative theories**
- Positive: accounting theory explains actual accounting practice
- Normative: accounting theory explains what should occur, not what actually does

**Alternatives to historical cost:**
- Current value accounting
- Increased use of fair values in financial statements

**Concepts of capital and capital maintenance**
- Financial capital maintenance: profit is the difference between income and expenses as in historical cost accounting
- Physical capital maintenance: profit is the increase in physical productive capital

**Current purchasing power (CPP)**
- Profit is difference between capital at beginning and end of period
- Capital must be maintained so must take account of effect of inflation

**Current cost accounting (CAA)**
- Capital maintenance approach based on maintaining operating capability
- Assets consumed, owned or sold should be shown at the value to the business, ie deprival value
Before you begin

If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

1. What is a normative accounting theory? (Section 1.3)
2. What is physical capital maintenance? (Section 3.1)
3. What is current purchasing power accounting? (Section 4)
4. What is current cost accounting? (Section 5)
1 Positive and normative accounting theory

1.1 Accounting theory

An accounting theory refers to having a body of knowledge which sets out the rules and regulations to be followed in accounting for transactions. Accounting theories should provide guidance to accounting practice and a basis for the future development of accounting standards.

There is no single theory of accounting, several have developed over the years. Theory usually underpins the development of standards. It can be argued that the IASB’s Conceptual Framework is an attempt at creating a body of accounting theory as it sets out the principles and process of accounting for items in the financial statements.

In this section there are two theories we will briefly look at, positive accounting theory and normative accounting theory.

1.2 Positive accounting theory

A positive approach to accounting is one where accounting theory is thought of as a body of knowledge that explains and attempts to predict actual accounting practice. Positive theory does not attempt to prescribe what businesses should or ought do, it merely predicts behaviour. It originated as a theory from the work of two academics, Watts and Zimmerman in the 1970s and 1980s. Therefore, information that provides guidance on accounting for particular events would be based on what has been observed as actual accounting practice rather than what should occur. It is an explanation of what actually happens rather than what should happen. Proponents of positive accounting theory can attempt to predict accounting behaviour by observing what actually happens and applying this to particular situations.

1.3 Normative accounting theory

Normative accounting theory differs from positive theory in that it explains what should occur rather than predicting what actually does occur. This theory suggests that accounting should specify how items should be defined and recognised. Normative theory may not be based on actual accounting practice as its basis is not what actually happens but what should happen. For example, the use of a conceptual framework and accounting standards based on that framework would be an example of normative theory.

In this chapter we will be looking at the two main systems that have been developed as possible alternatives to historical cost accounting: current cost accounting (CCA) and current purchasing power (CPP). These are also normative theories of accounting.

2 Alternatives to historical cost

Section overview

A number of alternatives to historical cost accounting have been developed and discussed. It is unlikely that the IASB will propose a full system of current cost accounting in the near future, but standards are requiring increasing use of fair values.

2.1 Current value accounting

The move towards current value accounting has already taken a number of steps. Entities are now permitted to revalue non-current assets such as land and buildings in line with market value, and financial assets and liabilities such as securities and investments can be carried at fair value, defined in several IFRS as: 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

These developments, and the use of fair values in acquisition accounting (to measure the assets of the subsidiary and therefore arrive at a realistic goodwill valuation) are relatively uncontroversial. However, there are those who would like fair value to be used more widely as a system of current value. In the US a
similar move is being advocated towards Current Value Accounting (CVA). Under CVA the original cost of an asset would be replaced with its discounted present value i.e. the present value of its future cash flows. This is obviously suitable for monetary items such as receivables and payables. The expected inflows and outflows would be discounted to present value using an interest rate which reflects the current time value of money. For assets such as vehicles, which do not yield a pre-determined future cash flow, current cost would be a more applicable measure – based either on the current cost of the original asset or on its replacement by a more up-to-date version. For inventories, current replacement cost or net realisable value would be indicated.

2.2 Historical cost accounting; does it have a future?

Investment analysts have argued that historical cost information is out of date and not relevant and that fair value information, based on active market prices, is the best available measure of future cash flows which an asset can be expected to generate.

This argument is heard increasingly in the US, where investors are the most highly-regarded user group for financial information, and the issue is likely to arise in the context of the IASB / FASB discussion on a joint conceptual framework.

We will now go on to discuss two alternative systems which have sought in the past to address the shortcomings of historical cost accounting – Current purchasing power (CPP) and Current cost accounting (CCA). We begin by looking at the fundamental difference between these two systems being a different concept of capital maintenance and therefore of profit.

3 Concepts of capital and capital maintenance

Section overview
- The concept of capital selected should be appropriate to the needs of the users of an entity’s financial statements.

Most entities use a financial concept of capital when preparing their financial statements.

3.1 Concepts of capital maintenance and the determination of profit

First of all, we need to define the different concepts of capital.

Definitions

Under a financial concept of capital, such as invested money or invested purchasing power, capital is the net assets or equity of the entity. The financial concept of capital is adopted by most entities. Focusing on the equity ownership of the entity is often referred to as the proprietary concept of capital: if we pay all profits out as dividends and inflation exists then in future our business will gradually run down, as our cash will become insufficient to buy replacement inventory.

Under an operating concept of capital (also known as physical concept of capital), such as operating capability, capital is the productive capacity of the entity based on, for example, units of output per day. Capital is looked at as the capacity to maintain a level of assets, by using replacement cost for our cost of sales we will set aside enough cash to buy replacement assets.

The definition of profit is also important.

Definition

Profit. The residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. Any amount over and above that required to maintain the capital at the beginning of the period is profit. (Conceptual Framework)
The main difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

(a) **Financial capital maintenance**: profit is the increase in nominal money capital over the period. This is the concept used in CPP, and used under historical cost accounting.

(b) **Operating or Physical capital maintenance**: profit is the increase in the physical productive capacity over the period. This is the concept used in CCA.

### 4 Current purchasing power (CPP)

#### 4.1 Capital maintenance

Profit can be measured as the difference between how wealthy a company is at the beginning and at the end of an accounting period.

(a) This wealth can be expressed in terms of the capital of a company as shown in its opening and closing statements of financial position.

(b) A business which maintains its capital unchanged during an accounting period can be said to have broken even.

(c) Once capital has been maintained, anything achieved in excess represents profit.

For this analysis to be of any use, we must be able to draw up a company’s statement of financial position at the beginning and at the end of a period, so as to place a value on the opening and closing capital. There are particular difficulties in doing this during a period of rising prices.

In conventional historical cost accounts, assets are stated in the statement of financial position at the amount it cost to acquire them (less any amounts written off in respect of depreciation or impairment in value). Capital is simply the difference between assets and liabilities.

For example, consider the following opening and closing statements of financial position of a company.

<table>
<thead>
<tr>
<th></th>
<th>Opening</th>
<th>Closing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inventory</strong></td>
<td>$500</td>
<td>$600</td>
</tr>
<tr>
<td><strong>Other net assets</strong></td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Capital</strong></td>
<td>1,500</td>
<td>1,600</td>
</tr>
</tbody>
</table>

Assuming that no new capital has been introduced during the year, and no capital has been distributed as dividends, the profit shown in historical cost accounts would be $100, being the excess of closing capital over opening capital. And yet in physical terms the company is no better off: it still has 100 units of inventory (which cost $5 each at the beginning of the period, but $6 each at the end) and its other net assets are identical. The 'profit' earned has merely enabled the company to keep pace with inflation.

An alternative to the concept of capital maintenance based on historical costs is to express capital in physical terms. On this basis, no profit would be recognised in the example above because the physical substance of the company is unchanged over the accounting period. Capital is maintained if at the end of the period the company is in a position to achieve the same physical output as it was at the beginning of the period. You should bear in mind that financial definitions of capital maintenance are not the only ones possible; in theory at least, there is no reason why profit should not be measured as the increase in a company’s physical capital over an accounting period.
4.2 The unit of measurement

Another way to tackle the problems of capital maintenance in times of rising prices is to look at the unit of measurement in which accounting values are expressed.

It is an axiom of conventional accounting, as it has developed over the years, that value should be measured in terms of money. It is also implicitly assumed that money values are stable, so that $1 at the start of the financial year has the same value as $1 at the end of that year. But when prices are rising, this assumption is invalid: $1 at the end of the year has less value (less purchasing power) than it had one year previously.

This leads to problems when aggregating amounts which have arisen at different times. For example, a company's non-current assets may include items bought at different times over a period of many years. They will each have been recorded in $, but the value of $1 will have varied over the period. In effect, the non-current asset figure in a historical cost statement of financial position is an aggregate of a number of items expressed in different units. It could be argued that such a figure is meaningless.

Faced with this argument, one possibility would be to re-state all accounts items in terms of a stable monetary unit. There would be difficulties in practice, but in theory there is no reason why a stable unit ($ CPP = $ of current purchasing power) should not be devised. In this section we will look at a system of accounting (current purchasing power accounting, or CPP) based on precisely this idea.

4.3 Specific and general price changes

We can identify two different types of price inflation.

When prices are rising, it is likely that the current value of assets will also rise, but not necessarily by the general rate of inflation. For example, if the replacement cost of a machine on 1 January 20X2 was $5,000, and the general rate of inflation in 20X2 was 8%, we would not necessarily expect the replacement cost of the machine at 31 December 20X2 to be $5,000 plus 8% = $5,400. The rate of price increase on the machinery might have been less than 8% or more than 8%. (Conceivably, in spite of general inflation, the replacement cost of the machinery might have gone down.)

(a) Specific price inflation, which measures price changes over time for a specific asset or group of assets.

(b) General price inflation, which is the average rate of inflation, which reduces the general purchasing power of money.

To counter the problems of specific price inflation some system of current value accounting may be used (such as current cost accounting). The capital maintenance concepts underlying current value systems do not attempt to allow for the maintenance of real value in money terms.

Current purchasing power (CPP) accounting is based on a different concept of capital maintenance.

Definition

CPP measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

When applied to historical cost accounting, CPP is a system of accounting which makes adjustments to income and capital values to allow for the general rate of price inflation.

4.4 Monetary and non-monetary items

It is obvious that during a period of inflation borrowers benefit at the expense of lenders. A sum borrowed at the beginning of the year will cost less to repay at the end of the year (although lenders will seek to allow for this in higher interest charges). Similarly, customers with balances owing benefit at the expense of suppliers. CPP accounting seeks to remove this element of 'holding gain'.

7: Alternative theories of accounting
Monetary items (cash, receivables, payables) cannot be restated as their amount is fixed. Non-monetary items (non-current assets and inventories) are restated in line with the general price index (at $c) and the balancing figure is equity.

**Question 1: CPP profits**

Rice and Price Co set up in business on 1 January 20X5 with no non-current assets, and cash of $5 000. On 1 January they acquired inventories for the full $5 000, which they sold on 30 June 20X5 for $6 000. On 30 November they obtained a further $2 100 of inventory on credit. The index of the general price level gives the following index figures:

<table>
<thead>
<tr>
<th>Date</th>
<th>Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 20X5</td>
<td>300</td>
</tr>
<tr>
<td>30 June 20X5</td>
<td>330</td>
</tr>
<tr>
<td>30 November 20X5</td>
<td>350</td>
</tr>
<tr>
<td>31 December 20X5</td>
<td>360</td>
</tr>
</tbody>
</table>

Calculate the CPP profits (or losses) of Rice and Price for the year to 31 December 20X5.

*(The answer is at the end of the chapter)*

### 4.5 The advantages and disadvantages of CPP accounting

#### 4.5.1 Advantages

(a) The restatement of asset values in terms of a **stable money value** provides a more meaningful **basis of comparison** with other companies. Similarly, provided that previous years' profits are re-valued into CPP terms, it is also possible to compare the current year's results with past performance.

(b) **Profit** is measured in 'real' terms and excludes 'inflationary value increments'. This enables better forecasts of future prospects to be made.

(c) CPP avoids the subjective valuations of current value accounting, because a single price index is applied to all non-monetary assets.

(d) CPP provides a stable monetary unit with which to value profit and capital.

(e) Since it is based on historical cost accounting, raw data is easily verified, and measurements of value can be readily audited.

#### 4.5.2 Disadvantages

(a) 'Generalised purchasing power' as measured by a retail price index, or indeed any other general price index, has no obvious practical significance.

'Generalised purchasing power has no relevance to any person or entity because no such thing exists in reality, except as a statistician's computation.'  

(T A Lee)

(b) The use of indices inevitably involves approximations in the measurements of value.

(c) The value **of assets in a CPP statement of financial position has less meaning than a current value statement of financial position**. It cannot be supposed that the CPP value of net assets reflects:

(i) The general goods and services that could be bought if the assets were released.

(ii) The consumption of general goods and services that would have to be forgone to replace those assets.

In this respect, a CPP statement of financial position has similar drawbacks to an historical cost statement of financial position (i.e. is fairly meaningless).
5 Current cost accounting (CCA)

5.1 Value to the business (deprival value)

Current cost accounting (CCA) reflects an approach to capital maintenance based on maintaining the operating capability of a business. The conceptual basis of CCA is that the value of assets consumed or sold, and the value of assets in the statement of financial position, should be stated at their value to the business (also known as 'deprival value').

Definition

The deprival value of an asset is the loss which a business entity would suffer if it were deprived of the use of the asset.

(a) A basic assumption in CCA is that 'capital maintenance' should mean maintenance of the 'business substance' or 'operating capability' of the business entity. As we have seen already, it is generally accepted that profit is earned only after a sufficient amount has been charged against sales to ensure that the capital of the business is maintained. In CCA, a physical rather than financial definition of capital is used: capital maintenance is measured by the ability of the business entity to keep up the same level of operating capability.

(b) 'Value to the business' is the required method of valuation in CCA, because it reflects the extra funds which would be required to maintain the operating capability of the business entity if it suddenly lost the use of an asset.

Value to the business, or deprival value, can be any of the following values:

(a) Replacement cost: in the case of non-current assets, it is assumed that the replacement cost of an asset would be its net replacement cost (NRC), its gross replacement cost minus an appropriate provision for depreciation to reflect the amount of its life already 'used up'.

(b) Net realisable value (NRV): what the asset could be sold for, net of any disposal costs.

(c) Economic value (EV), or value in use: what the existing asset will be worth to the company over the rest of its useful life.

The deprival value is the lower of replacement cost and recoverable amount. In turn the recoverable amount is the higher of net realisable value and economic value.

If the asset is worth replacing, its deprival value will always be net replacement cost. If the asset is not worth replacing, it might have been disposed of straight away, or else it might have been kept in operation until the end of its useful life.

We have already seen that if an asset is not worth replacing, the deprival value will be NRV or EV. However, there are many assets which will not be replaced either:

(a) Because the asset is technologically obsolete, and has been (or will be) superseded by more modern equipment.

(b) Because the business is changing the nature of its operations and will not want to continue in the same line of business once the asset has been used up.

Such assets, even though there are reasons not to replace them, would still be valued (usually) at net replacement cost, because this 'deprival value' still provides an estimate of the operating capability of the business.

5.2 CCA profits and deprival value

The deprival value of assets is reflected in the CCA income statement by the following means:

(a) Depreciation is charged on non-current assets on the basis of gross replacement cost of the asset (where NRC is the deprival value).

(b) Where NRV or EV is the deprival value, the charge against CCA profits will be the loss in value of the asset during the accounting period; i.e. from its previous carrying value to its current NRV or EV.
(c) **Goods sold** are charged at their replacement cost. Therefore if an item of inventory cost $15 to produce, and sells for $20, by which time its replacement cost has risen to $17, the CCA profit would be $3.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>20</td>
</tr>
<tr>
<td>Less replacement cost of goods sold</td>
<td>17</td>
</tr>
<tr>
<td>Current cost profit</td>
<td>3</td>
</tr>
</tbody>
</table>

### 5.3 CCA versus accounting for inflation

**Example: CCA versus accounting for inflation**

Suppose that Arthur Smith Co buys a non current asset on 1 January for $10 000. The estimated life of the asset is 5 years, and straight line depreciation is charged. At 31 December the gross replacement cost of the asset is $10 500 (5% higher than on 1 January) but general inflation during the year, as measured by the retail price index, has risen 20%.

(a) To maintain the value of the business against inflation, the asset should be revalued as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ Gross replacement cost ($10 000 × 120%)</td>
<td>12 000</td>
</tr>
<tr>
<td>Depreciation charge for the year (@ 20%)</td>
<td>2 400</td>
</tr>
<tr>
<td>Net value in the statement of financial position</td>
<td>9 600</td>
</tr>
</tbody>
</table>

(b) In CCA, the business maintains its operating capability if we revalue the asset as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ Gross replacement cost</td>
<td>10 500</td>
</tr>
<tr>
<td>Depreciation charge for the year (note)</td>
<td>2 100</td>
</tr>
<tr>
<td>NRC value in the statement of financial position</td>
<td>8 400</td>
</tr>
</tbody>
</table>

**Note**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Historical cost depreciation</td>
<td>2 000</td>
</tr>
<tr>
<td>CCA depreciation adjustment (5%)</td>
<td>100</td>
</tr>
<tr>
<td>Total CCA depreciation cost</td>
<td>2 100</td>
</tr>
</tbody>
</table>

CCA preserves the operating capability of the company but does not necessarily preserve it against the declining value in the purchasing power of money (against inflation). As mentioned previously, CCA is a system which takes account of specific price inflation (changes in the prices of specific assets or groups of assets) but not of general price inflation.

A strict view of current cost accounting might suggest that a set of CCA accounts should be prepared from the outset on the basis of deprival values. In practice, current cost accounts are usually prepared by starting from historical cost accounts and making appropriate adjustments.

### 5.4 CCA accounts

CCA accounts will include the following adjustments:

1. **Depreciation adjustment** – to amend depreciation in line with the gross replacement cost of the asset.
2. **Cost of sales adjustment** – to take account of increases in inventory prices and remove any element of profit based on this.
3. **Working capital adjustment** – to remove any element of profit or loss based on holding payables or receivables in a period of inflation.

You do not need to know how to do these adjustments, but you can see that they attempt to deal with the areas where inflation can lead to ‘holding gains’.
5.5 The advantages and disadvantages of current cost accounting

5.5.1 Advantages

(a) By excluding holding gains from profit, CCA can be used to indicate whether the dividends paid to shareholders will reduce the operating capability of the business.

(b) Assets are valued after management has considered the opportunity cost of holding them, and the expected benefits from their future use. CCA is therefore a useful guide for management in deciding whether to hold or sell assets.

(c) It is relevant to the needs of information users in:
   (i) Assessing the stability of the business entity.
   (ii) Assessing the vulnerability of the business (e.g. to a takeover), or the liquidity of the business.
   (iii) Evaluating the performance of management in maintaining and increasing the business substance.
   (iv) Judging future prospects.

(d) It can be implemented fairly easily in practice, by making simple adjustments to the historical cost accounting profits. A current cost statement of financial position can also be prepared with reasonable simplicity.

5.5.2 Disadvantages

(a) It is impossible to make valuations of EV or NRV without subjective judgments. The measurements used are therefore not objective.

(b) There are several problems to be overcome in deciding how to provide an estimate of replacement costs for non-current assets.

(c) The mixed value approach to valuation means that some assets will be valued at replacement cost, but others will be valued at NRV or EV. It is arguable that the total assets will, therefore, have an aggregate value which is not particularly meaningful because of this mixture of different concepts.

(d) It can be argued that 'deprival value' is an unrealistic concept, because the business entity has not been deprived of the use of the asset. This argument is one which would seem to reject the fundamental approach to 'capital maintenance' on which CCA is based.
Key chapter points

- An accounting theory refers to having a body of knowledge which sets out the rules and regulations to be followed in accounting for transactions. Accounting theories should provide reference to accounting practice and a basis for the future development of accounting standards. Two possible accounting theories are positive accounting theory and normative accounting theory.

- A number of alternatives to historical cost accounting have been developed and discussed. It is unlikely that the IASB will propose a full system of current cost accounting in the near future, but standards are requiring increasing use of fair values.

- The concept of capital selected should be appropriate to the needs of the users of an entity’s financial statements.

- Two alternative systems which have sought in the past to address the shortcomings of historical cost accounting are current purchasing power (CPP) and current cost accounting (CCA).

- CPP measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

- CCA reflects an approach to capital maintenance based on maintaining the operating capability of a business.
Quick revision questions

1. What accounting theory is based on actual accounting practice?
   A. positive theory
   B. normative theory

2. What does the following statement describe?
   'the point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity’s return on capital and its return of capital;'
   A. historical cost
   B. fair value
   C. current cost accounting
   D. capital maintenance

3. In financial capital maintenance, how is the profit for the period calculated?
   A. it is the difference between income and expenses for a period after taking account of operating capital maintenance adjustments
   B. it is the difference between income and expenses in a period with no adjustment for operating capital maintenance

4. What is specific price inflation?
   A. inflation that affects the general purchasing power of money
   B. inflation that only affects a particular group of assets

5. How does current purchasing power (CPP) accounting measure profits?
   A. profit is the difference between income and expenses after allowing for the effect of inflation
   B. profit is the difference between income and expenses after ensuring that physical capital has been maintained

6. What is the deprival value of an asset?
   A. original cost of the asset
   B. the amount the asset could be exchanged in an arm’s length transaction
   C. the loss the business would suffer if it no longer owned the asset
   D. original cost less depreciation to reflect how long the asset has been owned

7. Which one of the following is not used as a measure of deprival value?
   A. replacement cost
   B. net realisable value
   C. economic value
   D. fair value

8. Of which type of inflation does current cost accounting take account?
   A. specific inflation
   B. general inflation
Answers to quick revision questions

1. A Normative accounting theory explains what *should* occur rather than predicting what actually does occur.

2. D Capital maintenance

3. B Financial capital maintenance makes no reference to the operating capacity of a business or whether profits made are sufficient to continue to operate at a previous level. Instead, it concentrates simply on monetary profit.

4. B A refers to general price inflation.

5. A B refers to current cost accounting.

6. C The deprival value of an asset is the amount that a business would lose if the asset were damaged or lost. It is the lower of replacement cost and recoverable value.

7. D Deprival value is the lower of replacement cost and recoverable value. Recoverable value is the higher of sales value (net realisable value) and value in use (economic value).

The approach is to prepare a CPP income statement.

<table>
<thead>
<tr>
<th>Description</th>
<th>$c</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales ($6,000 × 360/330)</td>
<td>$6,545</td>
</tr>
<tr>
<td>Less cost of goods sold ($5,000 × 360/300)</td>
<td>$6,000</td>
</tr>
<tr>
<td></td>
<td>$545</td>
</tr>
<tr>
<td>Loss on holding cash for 6 months*</td>
<td>$(545)</td>
</tr>
<tr>
<td>Gain by owing payables for 1 month**</td>
<td>$60</td>
</tr>
<tr>
<td>CPP profit</td>
<td>$485</td>
</tr>
</tbody>
</table>

* ($6,000 × 360/330) − $6,000 = $545
** ($2,100 × 360/350) − $2,100 = $60

Note that under historic cost accounting the gross profit would be $1,000 ($6,000 − $5,000).
Chapter 8
Reporting and disclosure of performance

<table>
<thead>
<tr>
<th>Learning objectives</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reporting and disclosure of performance</td>
<td>LO8</td>
</tr>
<tr>
<td>Explain agency theory in the context of company activity</td>
<td>LO8.1</td>
</tr>
<tr>
<td>Define the role and authority of the agent</td>
<td>LO8.2</td>
</tr>
<tr>
<td>Explain the separation of ownership and control in a large corporation</td>
<td>LO8.3</td>
</tr>
<tr>
<td>Define an agency cost</td>
<td>LO8.4</td>
</tr>
<tr>
<td>Identify the types of agency costs involved in monitoring the activities of the agent</td>
<td>LO8.5</td>
</tr>
<tr>
<td>Identify the components of a set of financial statements</td>
<td>LO8.6</td>
</tr>
<tr>
<td>Identify the difference between mandatory and non-mandatory information that is produced in the annual report</td>
<td>LO8.7</td>
</tr>
<tr>
<td>Identify the different types of financial and non-financial information produced in the annual report</td>
<td>LO8.8</td>
</tr>
<tr>
<td>Identify the possible advantages and disadvantages of providing financial and non-financial information in the annual report</td>
<td>LO8.9</td>
</tr>
</tbody>
</table>

**Topic list**

1. Agency theory
2. Information provided in annual reports
This chapter examines agency theory and the elements of the relationship between shareholders and directors. We take this further by looking at the information disclosed in the financial statements that enables shareholders to assess the performance of the company. This information is a combination of mandatory and voluntary.

**Agency theory**
- Principal tasks the agent with undertaking a task on their behalf
- Shareholders task directors to run company on their behalf
- Problems occur if agent doesn’t act in best interest of principal
- Agency costs incurred by principal monitoring activities of agent
- Costs can easily be verified

**Information provided in annual report**
- Mandatory information includes financial statements
- Voluntary information includes:
  - sustainability reports
  - management commentary
  - corporate governance
  - risk information
- Aim of information is to provide shareholders with understanding of the company’s activities in the period
If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

1. What is an agency relationship?  
   *(Section 1.1)*

2. Which of the following statements with respect to a principal – agent relationship is true?  
   *(Section 1.2)*
   - A an agent must keep in confidence what he knows of the principal's affairs until the relationship has ceased
   - B if an agent receives commission from a third party, the contract between the principal and agent is still valid provided that the commission is passed to the principal
   - C an agent may delegate his task to another party in certain circumstances
   - D an agent who agrees to act as agent has a contractual obligation to complete his duties even where he receives no reward

3. What principal – agent relationships may exist in the context of a company?  
   *(Sections 1.3 and 1.7)*

4. What components must be included within the financial statements of an entity?  
   *(Section 2.2.1)*

5. What is the purpose of corporate governance disclosures?  
   *(Section 2.2.1)*

6. What are the advantages of disclosing non-mandatory information such as social reports?  
   *(Section 2.2.3)*
1 Agency theory

Section overview

- Agency is extremely important in corporate governance as often the directors / managers are acting as agents for the owners. Corporate governance frameworks aim to ensure directors / managers fulfil their responsibilities as agents by requiring disclosure and suggesting they be rewarded on the basis of performance.

1.1 Nature of agency

Definition

Agency relationship is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent. (Jensen and Meckling)

There are a number of specific types of agent. These have either evolved in particular trades or developed in response to specific commercial needs. The most common in accounting is the relationship between directors and shareholders as the shareholders task the directors with running the company on their behalf.

1.2 Accountability and fiduciary responsibilities

1.2.1 Accountability

Definition

In the context of agency, accountability means that the agent is answerable under the contract to his principal and must account for the resources of his principal and the money he has gained working on his principal's behalf.

Potentially two problems arise with this:

- How does the principal enforce this accountability – this is the agency problem – see below; as we shall see, the corporate governance systems developed to monitor the behaviour of directors have been designed to address this issue.

- What if the agent is accountable to parties other than his principal – how does he reconcile possibly conflicting duties?

1.2.2 Fiduciary duty

Under common law it is usually the case that company directors owe a fiduciary duty to the company to exercise their powers in what they honestly consider to be the interests of the company. This duty is owed to the company and not generally to individual shareholders.

Clearly the concepts of fiduciary duty and accountability are very similar though not identical. Where certain wider responsibilities are enshrined in law, do directors have a duty to go beyond the law, or can they regard the law as defining what society as a whole requires of them?

1.2.3 Performance

The agent who agrees to act as an agent for reward has a contractual obligation to perform his agreed task. An unpaid agent is not bound to carry out his agreed duties. Any agent may refuse to perform an illegal act.
1.2.4 **Obedience**

The agent must act strictly in **accordance with his principal's instructions** provided these are lawful and reasonable. Even if he believes disobedience to be in his principal's best interests, he may not disobey instructions. Only if he is asked to commit an illegal act may he do so.

1.2.5 **Skill**

A paid agent undertakes to maintain the standard of **skill and care** to be expected of a person in his profession.

1.2.6 **Personal performance**

The agent is presumably selected because of his personal qualities and owes a duty to **perform his task himself** and not to delegate it to another. But he may delegate in a few special circumstances, if delegation is necessary, such as a solicitor acting for a client would be obliged to instruct a stockbroker to buy or sell listed securities on a Stock Exchange.

1.2.7 **No conflict of interest**

The agent owes to his principal a duty not to put himself in a situation where his **own interests conflict** with those of the principal; for example, he must not sell his own property to the principal even if the sale is at a fair price.

1.2.8 **Confidence**

The agent must keep in **confidence** what he knows of his principal's affairs even after the agency relationship has ceased.

1.2.9 **Any benefit**

Any benefit must be handed over to the principal unless he **agrees** that the agent may **retain it**. Although an agent is entitled to his agreed remuneration, he must account to the principal for any other **benefits**. If he accepts from the other party any **commission or reward** as an inducement to make the contract with him, it is considered to be a bribe and the contract is fraudulent.

1.3 **Agency in the context of the director-shareholder relationship**

Agency is a significant issue in corporate governance because of the **dominance of the limited liability company**. For larger companies this has led to the **separation of ownership of the company** from its **management**. The owners (the shareholders) can be seen as the **principal**, the management of the company as the **agents**.

Although ordinary **shareholders** (equity shareholders) are the owners of the company to whom the board of directors are accountable as agents, the actual powers of shareholders tend to be restricted. They normally have no right to inspect the books of account, and their forecasts of future prospects are gleaned from the annual report and accounts, stockbrokers, journals and daily newspapers.

The day-to-day running of a company is the responsibility of the directors and other managers to whom the directors delegate, not the shareholders. For these reasons, therefore, there is the potential for **conflicts of interest** between management and shareholders.

1.4 **The agency problem**

The agency problem in limited liability companies derives from the principals (owners) not being able to run the business themselves and therefore having to rely on agents (directors) to do so for them. This **separation of ownership from management** can cause issues if there is a breach of trust by directors through intentional action, omission, neglect or incompetence. This breach may arise because the directors are **pursuing their own interests** rather than those of the shareholders or because they have **different attitudes to risk-taking** than the shareholders.

For example, if managers hold none or very little of the equity shares of the company they work for, what is to stop them from working inefficiently, concentrating too much on achieving short-term profits and hence maximising their own bonuses, not bothering to look for profitable new investment opportunities, or giving themselves high salaries and perks (e.g. bonuses and other benefits or advantages)?
One power that shareholders possess is the right to **remove the directors** from office. But shareholders have to take the initiative to do this, and in many companies, the shareholders lack the energy and organisation to take such a step. Ultimately they can vote in favour of a takeover or removal of individual directors or entire boards, but this may be undesirable for other reasons.

### 1.5 Agency costs

To alleviate the agency problem, shareholders have to take steps to exercise control, such as attending annual general meetings or ultimately becoming directors themselves. However, agency theory assumes that it will be **expensive and difficult** to:

- Verify what the agent is doing, partly because the agent has more available information about his activities than the principal does.
- Introduce mechanisms to control the activities of the agent.

**Agency costs** arise therefore, from attempts by principals to monitor the activities of agents, and may be viewed in monetary terms, resources consumed or time taken in monitoring. There will also be costs involved in establishing methods of control such as contracts. These costs may not just be incurred by the shareholders. To fulfil the requirements imposed on them and to obtain the rewards of fulfilment, managers will spend time and resources proving that they are maximising shareholder value by, for example, providing increased disclosure.

**Types of agency costs** include salaries paid to directors in their role as agents running the company on shareholders’ behalf. Additionally, the principal incurs **monitoring costs** to ensure that the agent is doing what they should be. This can include costs of preparing financial information including corporate governance reports, the cost of an external auditor who reports on the financial statements, and the internal audit function. An agency cost can also include the shareholders’ personal cost of accepting higher risks than they would perhaps wish to, as they are tasking the agent with running the business on their behalf.

### 1.6 Resolving the agency problem: alignment of interests

Agency theory sees employees of businesses, including managers, as individuals, each with his or her own objectives. Within a department of a business, there are departmental objectives. If achieving these various objectives leads also to the achievement of the objectives of the organisation as a whole, there is said to be **alignment of interests**.

**Definition**

**Alignment of interests** is agreement between the objectives of agents acting within an organisation and the objectives of the organisation as a whole. Alignment of interests is sometimes referred to as goal congruence, although goal congruence may also be used in other ways.

Alignment of interests may be better achieved and the ‘agency problem’ better dealt with by giving managers some profit-related pay, or by providing incentives that are related to profits or share price. Examples of such remuneration incentives are:

(a) **Profit-related/economic value-added pay**

   Pay or bonuses related to the size of profits.

(b) **Rewarding managers with shares**

   This might be done when a private company ‘goes public’ and managers are invited to subscribe for shares in the company at an attractive offer price. In a **management buy-out** or **buy-in** (the latter involving purchase of the business by new managers; the former by existing managers), managers become joint owner-managers.

(c) **Executive share option plans (ESOPs)**

   In a share option scheme, selected employees are given a number of share options, each of which gives the holder the right after a certain date to subscribe for shares in the company at a fixed price. The value of an option will increase if the company is successful and its share price goes up, therefore giving managers an incentive to make decisions to increase the value of the company, actions congruent with wider shareholder interests.
Such measures might merely encourage management to adopt ‘creative accounting’ methods which will distort the reported performance of the company in the service of the managers’ own ends. The global financial crisis has highlighted issues with the use of such remuneration incentives.

An alternative approach is to attempt to monitor managers’ behaviour, for example by establishing ‘management audit’ procedures, to introduce additional reporting requirements, or to seek assurances from managers that shareholders’ interests will be foremost in their priorities. The most significant problem with monitoring is likely to be the agency costs involved, as they may imply significant shareholder engagement with the company.

1.7 Other agency relationships

1.7.1 Shareholder-auditor relationship

The shareholder-auditor relationship is another agency relationship on which corporate governance guidance has focused. The shareholders are the principals, the auditors are the agents and the audit report the key method of communication. The agency problem with auditors is that auditors may not be independent of management; they may become too close or are afraid that management will not give them non-audit work. The Code of Ethics that applies to professional accounting bodies, such as CPA Australia, guards against such outcomes.

1.7.2 Other relationships

Other significant agency relationships include directors themselves acting as principals to managers / employees as agents. It is, of course, a significant responsibility of directors to make sure that this agency relationship works by establishing appropriate systems of performance measurement and monitoring.

1.8 Other concepts in corporate governance

1.8.1 Openness/transparency

Definition

Transparency means open and clear disclosure of relevant information to shareholders and other stakeholders and also not concealing information when it may affect decisions. It means open discussions and a default position of information provision rather than concealment.

Disclosure in this context clearly includes information in the financial statements, not just the numbers and notes to the accounts but also narrative statements such as the directors’ report and the operating and financial review. It also includes all voluntary disclosure, that is disclosure above the minimum required by law or regulation. Voluntary corporate communications include management forecasts, analysts’ presentations, press releases, information placed on websites and other reports such as stand-alone environmental or social reports.

The main reason why transparency is so important relates to the agency problem discussed above, that of the potential conflict between owners and managers. Without effective disclosure the position could be unfairly weighted towards managers, since they have far more knowledge of the company’s activities and financial situation than owners / investors. Avoidance of this information asymmetry requires not only effective disclosure rules, but strong internal controls that ensure that the information that is disclosed is reliable.

Linked with the agency issue, publication of relevant and reliable information underpins stock market confidence in how companies are being governed and therefore significantly influences market prices. International accounting standards and stock market regulations based on corporate governance codes, require information published to be true and fair. Information can only fulfil this requirement if adequate disclosure is made of uncertainties and adverse events.

Circumstances where concealment may be justified include discussions about future strategy (knowledge of which would benefit competitors), confidential issues relating to individuals and discussions leading to an agreed position that is then to be made public.
1.8.2 Accountability

Definition

Corporate accountability refers to whether an organisation and in particular its directors are answerable in some way for the consequences of their actions.

Accountability of directors to shareholders has always been an important part of company law, well before the development of the corporate governance codes. For example, companies have been required to provide financial information to shareholders on an annual basis and hold annual general meetings. However, particularly because of the corporate governance scandals of the last 30 years, such as Enron, the collapse of Lehman Brothers and the Australian collapses of Allco Finance Group Ltd and Westpoint Corporation Pty Ltd, investors have demanded greater assurance that directors are acting in their interests.

Question 1: Duties of an agent

What duties does an agent have when acting for a principal?

(The answer is at the end of the chapter)

2 Information provided in annual reports

Section overview

- Annual reports must convey a fair and balanced view of the organisation. They should state whether the organisation has complied with governance regulations and codes. It is considered best practice to give specific disclosures about the board, internal control reviews, going concern status and relations with stakeholders.

2.1 Importance of reporting

Reporting performance to shareholders is of key importance as a result of the agency issues discussed above. One key principle of good corporate governance is for companies to regularly engage in effective and fair communication with shareholders. Companies should aim to be as descriptive, detailed and forthcoming as possible.

Good disclosure helps reduce the gap between the information available to directors and the information available to shareholders, and therefore addresses one of the key difficulties of the agency relationship between directors and shareholders.

2.2 Reporting requirements

2.2.1 Mandatory information

According to IAS 1 Presentation of financial statements, a complete set of financial statements includes the following components:

(a) Statement of financial position
(b) Statement of comprehensive income
(c) Statement of changes in equity
(d) Statement of cash flows
(e) Accounting policies and explanatory notes

The preparation of these statements is the responsibility of the board of directors. IAS 1 also encourages a financial review by management and the production of any other reports and statements which may aid users.
The **auditor's report** must also be disclosed in the financial statements as it provides an opinion as to whether the financial statements show a fair presentation / true and fair view of the performance and position of the entity.

Reporting requirements are also found in the **listing requirements of stock exchanges**. For example, in Australia the Australian Securities Exchange (ASX) Operating Rules include the ASX Listing Rules, the ASX Operating Rules, the ASX Clear Operating Rules and the ASX Settlement Operating Rules. While these rules are not part of regulatory company supervision, companies who are listed on the ASX must comply with the Operating Rules. This is the same situation as the UK where the Combined Code of Corporate Governance is not a mandatory standard, but companies listed on the London Stock Exchange must prepare corporate governance disclosure, so for listed companies it becomes a mandatory requirement.

**Corporate governance disclosure** helps the shareholders understand the way the company is being run and ensures that the directors have proper procedures in place to deal with accountability, audits, directors' roles and responsibilities, internal control and relations with shareholders.

### 2.2.2 Non-mandatory information

There has been an increasing trend for companies to provide a great deal of additional information in their annual report. This information is largely voluntary and is disclosed in order to improve transparency and accountability to shareholders. A company may also take into account the information wishes of other stakeholders such as the local community, environmental pressure groups, local government, employees and so on. All this means that a company may be reporting to more than just shareholders and therefore the amount of information disclosed can be very large indeed.

There are a number of different areas of **non-mandatory disclosure**:

(a) **Social and environmental reporting** or **sustainability reporting**, which includes the nature and extent of social, transformation, ethical, safety, health and environmental management policies and practices.

(b) A business review such as the **management commentary** which should set out the directors' analysis of the current and proposed future performance of the business. It should include discussion and interpretation of the performance of the business and the future risks and prospects of the company.

(c) **Risk information** – this may detail the work of the risk committee whose role is to identify, assess and minimise risks facing the organisation.

### 2.2.3 Advantages and disadvantages of disclosing non-mandatory information

Disclosing information voluntarily, going beyond what is required by law or listing rules can be advantageous for the following reasons:

(a) **Wider information provision**

Disclosures covering wider areas than those required by law or regulations should give stakeholders a better idea of the environment within which the company is operating and how it is responding to that environment. This should enable investors to carry out a more informed analysis of the strategies the company is pursuing, reducing information asymmetry between directors and shareholders.

(b) **Different focus of information**

Voluntary information can be focused on future strategies and objectives, giving readers a different perspective from compulsory information that tends to be focused on historical accounting data.

(c) **Assurance about management**

Voluntary information provides investors with further yardsticks to judge the performance of management. Its disclosure demonstrates to shareholders that managers are actively concerned with all aspects of the company's performance.

While the provision of detailed information can be very useful and goes a long way in achieving the corporate governance principles of transparency and accountability, the **downside** is that there is such a large amount of information that some shareholders may experience 'information overload'.

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LO 8.7
LO 8.8
LO 8.9
In response to this, many companies ask shareholders if they want to receive a summarised annual report and accounts, and then publish the full report and accounts plus the other voluntary information on their website. This allows users to choose how much they want to read.

For example, Tesco plc, a UK supermarket group has a vast amount of information on its corporate website, but users can create their own report by only selecting the information they wish to read and therefore avoid the information they are not interested in.

Many of the top 20 Australian publicly listed companies allow shareholders to view annual reports interactively online. This means they can access any annual report or financial statement and launch interactive features allowing them to navigate through the report or statement as they wish. Companies providing this feature include BHP Billiton Ltd, Telstra Corporation Ltd, Wesfarmers Ltd, the Westfield Group and Woolworths Ltd.

Other disadvantages of the disclosure of non-mandatory information include:

(a) **Costs of preparation**

The costs of assimilating information in respect of environmental issues and such like may far outweigh any benefit which the company receives as a result of disclosure.

(b) **Loss of competitive advantage**

Particularly where disclosure includes detail of future strategies and objectives, competitors may gain useful knowledge about a company which they use to improve their own position in the market.

(c) **Usefulness of information**

There is an argument that non-financial non-mandatory information is irrelevant to investors who are more interested in financial factors in order to assess the return on their investment. Equally, such information can generally not be compared with like information for other entities due to the varied performance measures and presentation used.
Agency is extremely important in corporate governance as often the directors / managers are acting as agents for the owners. Corporate governance frameworks aim to ensure directors / managers fulfil their responsibilities as agents by requiring disclosure and suggesting they be rewarded on the basis of performance.

Annual reports must convey a fair and balanced view of the organisation. They should state whether the organisation has complied with governance regulations and codes. It is considered best practice to give specific disclosures about the board, internal control reviews, going concern status and relations with stakeholders.
Quick revision questions

1. What does the following statement define?
   'A contract under which one or more persons engage another person to perform some service on their behalf'.
   A. substance over form
   B. accountability
   C. agency theory
   D. principal theory

2. What is fiduciary duty?
   A. the need for directors to prepare financial statements that show a true and fair view
   B. the need for directors to act in the best interests of the company and not out of self-interest
   C. the need for directors to disclose their personal shareholding in a company they manage
   D. the directors running a company on behalf of the shareholders

3. Which of the following are examples of agency costs?
   I. Directors' salaries
   II. External audit fees
   III. Finance department salaries
   A. I only
   B. II only
   C. I and II only
   D. I, II and III

4. According to IAS 1 Presentation of financial statements, which of the following are mandatory disclosures in the annual financial report?
   I. Income statement
   II. Accounting policies
   III. Environmental report
   IV. Risk review
   A. I only
   B. I and II only
   C. I, II and IV only
   D. I, II, III and IV

5. ABC Co is a large company, listed on the Australian Securities Exchange (ASX). Is it required to prepare a corporate governance report as part of its annual financial report?
   A. yes, the report must be disclosed
   B. no, the report is not required

6. Which of the following must be disclosed in a non-listed company's annual report?
   A. environmental report
   B. management commentary
   C. accounting policies
   D. corporate governance statement
Answers to quick revision questions

1. C An agency relationship involves a contract under which the principals engage the agent to perform some service on their behalf and delegate some decision-making authority to the agent.

2. B Company directors owe a fiduciary duty to a company to exercise their powers in what they honestly consider to be the interests of the company. This duty is owed to the company and not generally to individual shareholders.

3. C Agency costs include:
   - salaries paid to directors in their role as agents
   - monitoring costs to ensure that the agent is doing what they should be (such as the costs of preparing financial information, the cost of an external auditor and the internal audit function).

4. B Other mandatory items include the statement of financial position, statement of cash flows and statement of changes in equity. Narrative reports such as a risk review and environmental report are not mandatory, however may be included in annual accounts.

5. A The corporate governance report is required as part of the listing rules.

6. C Per IAS 1, the accounting policies must be disclosed. Corporate governance would be good practice but as the company is unlisted it is not mandatory.
Answer to chapter question

1. When an agent acts for a principal they have a number of duties:

   - The agent who agrees to act as an agent for reward has a contractual obligation to perform his agreed task.

   - The agent must act strictly in accordance with his principal’s instructions provided these are lawful and reasonable. Even if he believes disobedience to be in his principal’s best interests, he may not disobey instructions. Only if he is asked to commit an illegal act may he refuse.

   - A paid agent undertakes to maintain the standard of skill and care to be expected of a person in his profession.

   - The agent owes a duty to perform his task himself and not to delegate it to another other than in certain special circumstances.

   - The agent owes to his principal a duty not to put himself in a situation where his own interests conflict with those of the principal.

   - The agent must keep in confidence what he knows of his principal’s affairs even after the agency relationship has ceased.

   - An agent must hand over any benefit to the principal unless the principal agrees that the agent may retain it.
Chapter 9
Efficiency in capital markets and company reporting

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Topic list
1 The efficient market hypothesis (EMH)
2 Information available to shareholders
3 Content of company reports
This chapter deals firstly with the determination of share prices. As we shall see, there are various theories which seek to provide a rationale for share price movement. The most important of these is the **efficient market hypothesis**, which provides theoretical underpinning for how markets take into account new information.

We then look at the sources of information available on a company’s activities.

**Efficiency in capital markets and company reporting**

**The efficient market hypothesis**
- Idea that stock market reacts immediately to information that is available
  Three types:
  - weak form: share price reflects information about past changes in price
  - semi-strong: share price reflects information about past changes in price plus all public knowledge
  - strong: share price reflects all information whether publicly available or not

**Information available to shareholders**
- Many sources of company information:
  - annual report
  - chairman’s statement
  - directors’ report
  - corporate governance
  - corporate social responsibility
  - auditors’ report
  - management commentary
If you have studied these topics before, you may wonder whether you need to study this chapter in full. If this is the case, please attempt the questions below, which cover some of the key subjects in the area.

If you answer all these questions successfully, you probably have a reasonably detailed knowledge of the subject matter, but you should still skim through the chapter to ensure that you are familiar with everything covered.

There are references in brackets indicating where in the chapter you can find the information, and you will also find a commentary at the back of the Study Manual.

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1 The efficient market hypothesis (EMH)

Section overview

- The theory behind share price movements can be explained by the three forms of the efficient market hypothesis:
  - Weak form efficiency implies that prices reflect all relevant information about past price movements and their implications.
  - Semi-strong form efficiency implies that prices reflect past price movements and publicly available knowledge.
  - Strong form efficiency implies that prices reflect past price movements, publicly available knowledge and inside knowledge.

Definition

The efficient market hypothesis (EMH) is the hypothesis that the stock market reacts immediately to all the information that is available. Therefore, a long-term investor cannot obtain higher than average returns from a well-diversified share portfolio.

1.1 The definition of efficiency

Different types of efficiency can be distinguished in the context of the operation of financial markets:

(a) Allocative efficiency

If financial markets allow funds to be directed towards companies which make the most productive use of them, then there is allocative efficiency in these markets.

(b) Operational efficiency

Transaction costs are incurred by participants in financial markets, for example commissions on share transactions, margins between interest rates for lending and for borrowing, and loan arrangement fees. Financial markets have operational efficiency if transaction costs are kept as low as possible. Transaction costs are kept low where there is open competition between brokers and other market participants.

(c) Information processing efficiency

The information processing efficiency of a stock market means the ability of a stock market to price stocks and shares fairly and quickly. An efficient market in this sense is one in which the market prices of all securities reflect all the available information.

1.2 Features of efficient markets

It has been argued that the stock markets are efficient capital markets, that is, markets in which:

(a) The prices of securities bought and sold reflect all the relevant information which is available to the buyers and sellers: in other words, share prices change quickly to reflect all new information about future prospects.

(b) No individual dominates the market.

(c) Transaction costs of buying and selling are not so high as to discourage trading significantly.

(d) Investors are rational.

(e) There are low, or no, costs of acquiring information.
1.3 **Impact of efficiency on share prices**

If the stock market is efficient, share prices should vary in a rational way:

(a) If a company makes an investment with a **positive net present value** (NPV), shareholders will get to know about it and the market price of its shares will rise in anticipation of future dividend increases.

(b) If a company makes a **bad investment** shareholders will find out and so the **price** of its **shares** will fall.

(c) If interest rates rise, **shareholders will want a higher return** from their investments, so market prices will fall.

1.4 **Varying degrees of efficiency**

There are three degrees or ‘forms’ of **efficiency**: **weak form**, **semi-strong form** and **strong form**.

1.4.1 **Weak form efficiency**

Under the weak form hypothesis of market efficiency, share prices reflect all available information about past changes in the share price.

Since new information arrives unexpectedly, changes in share prices should occur in a **random fashion**. If it is correct, then using technical analysis to study past share price movements will not give anyone an advantage, because the information they use to predict share prices is already reflected in the share price.

1.4.2 **Semi-strong form efficiency**

If a stock market displays semi-strong efficiency, current share prices reflect:

- All relevant information about past price movements and their implications, and
- All knowledge which is available publicly.

This means that individuals cannot ‘beat the market’ by reading the newspapers or annual reports, since the information contained in these will be reflected in the share price.

Tests to prove semi-strong efficiency have concentrated on the speed and accuracy of stock market response to information and on the ability of the market to **anticipate share price changes** before new information is formally announced. For example, if two companies plan a merger, share prices of the two companies will inevitably change once the merger plans are formally announced. The market would show semi-strong form efficiency, however, if it were able to anticipate such an announcement so that share prices of the companies concerned would change in advance of the merger plans being confirmed.

Research in both the UK and the US has suggested that market prices anticipate mergers several months before they are formally announced, and the conclusion drawn is that the stock markets in these countries **do** exhibit semi-strong form efficiency.

1.4.3 **Strong form efficiency**

If a stock market displays a strong form of efficiency, share prices reflect **all** information whether publicly available or not:

- From past price changes.
- From public knowledge or anticipation.
- From specialists’ or experts’ insider knowledge (e.g. investment managers).

1.5 **Implications of efficient market hypothesis for the financial manager**

If the markets are quite strongly efficient, the main consequence for financial managers will be that they simply need to **concentrate** on **maximising the net present value** of the **company’s investments** in order to maximise the wealth of shareholders. Managers need not worry, for example, about the effect on share prices of financial results in the published accounts because investors will make **allowances** for **low profits** or **dividends** in the current year if higher profits or dividends are expected in the future.
If the market is strongly efficient, there is little point in financial managers trying strategies that will attempt to mislead the markets:

(a) There is no point for example in trying to identify a correct date when shares should be issued, since share prices will always reflect the true worth of the company.

(b) The market will identify any attempts to window dress the accounts and put an optimistic spin on the figures.

(c) The market will decide what level of return it requires for the risk involved in making an investment in the company. It is pointless for the company to try to change the market’s view by issuing different types of capital instruments.

Similarly if the company is looking to expand, the directors will be wasting their time if they seek as takeover targets companies whose shares are undervalued, since the market will fairly value all companies’ shares.

Only if the market is semi-strongly efficient, and the financial managers possess inside information that would significantly alter the price of the company's shares if released to the market, could they perhaps gain an advantage. However, attempts to take account of this inside information may breach insider-dealing laws.

The different characteristics of a semi-strong form and a strong form efficient market therefore affect the timing of share price movements in cases where the relevant information becomes available to the market eventually. The difference between the two forms of market efficiency is concerned with when the share prices change, not by how much prices eventually change.

### 1.6 Criticisms of the efficient market hypothesis

The EMH has been the cornerstone of financial management and economic theories for more than 30 years. However, recent events such as the dot.com bubble and the current global financial crisis have brought forward criticisms of the EMH. The dot.com bubble is the term used to describe the sequence of events in the 1990s when newly formed businesses trading on the Internet were set up, expanded rapidly but then declined as rapidly. Their share prices increased far out of proportion to the actual value of the company concerned and many investors lost large sums of money when the bubble burst. It has been argued that as one of the assumptions of EMH theory is that investors are rational then the prices in the market will always be correct. However, arguments from the school of behavioural finance insist that investors are not always rational and therefore market prices are not always correct. This is particularly the case in scenarios such as the dot.com rise and collapse.

In more recent times the EMH has been attacked by critics who argue that belief in rational markets has had much to do with the current global financial crisis. The EMH states that prices cannot be wrong: if the price is wrong then market forces will act to seek to profit from the error and therefore correct it. This is perhaps its fatal flaw. As a further example, rating agencies in the US assumed that sub-prime mortgages would behave in a random fashion – there would never be large amounts of people defaulting at the same time! Some commentators have gone as far as to state that the global financial crisis was in fact caused by the EMH claiming that belief in the hypothesis led financial leaders to underestimate the dangers of the bursting of ‘bubbles’ of vastly over-inflated asset values.

**Question 1: EMH**

Briefly describe the three forms of capital market efficiency.

(The answer is at the end of the chapter)
Information comes from financial statements, financial databases, the financial press and the internet. The previous chapter examined the nature of mandatory and non-mandatory information provided to shareholders. This section provides a brief overview of the information provided to shareholders to improve their decision-making.

2.1.1 Availability of company information

There has been an increase in the amount of information a shareholder can obtain about a company’s activities over the last few years. As well as the annual report, many companies provide detailed corporate social responsibility reports, press releases, interim information and much more on their websites.

While it is advantageous to provide such information, there is a danger of information overload for investors due to the volume of information available. This is made more complicated by the existence of voluntary guidelines for environmental and sustainability reporting. While adherence to these guidelines means that companies can show their commitment to this reporting, it also means there is a lot of detailed information that needs to be disclosed and this could be confusing for some users.

2.1.2 Dividend information

It has been argued that shareholders see dividend decisions as passing on new information about the company and its prospects. A dividend increase is usually viewed by markets to be good news and a dividend decrease to be bad news, but it may be that the market will react to the difference between the actual dividend payments and the market’s expectations of the level of dividend. For example, the market may be expecting a cut in dividend but if the actual decrease is less than expected, the share price may rise.

2.2 Benefits of providing company information to shareholders

In the last chapter, we looked at some of the benefits of disclosing more information than is actually required by law, accounting standards or other regulation. Later in this chapter we will look in more detail at some of the additional information that large listed companies provide to the public as part of, or alongside, their annual report. Some of this information, such as corporate governance disclosures, may be required by listing authorities. However, other information, such as a corporate social responsibility reports, is largely provided voluntarily.

There is an argument that companies provide such information partly through ‘peer pressure’. Once a certain number of organisations are providing a certain type of disclosure, this becomes accepted ‘best practice’. Twenty years ago, a relatively small number of organisations published an environmental report, now, most large listed companies do so.

There are other powerful incentives in place to provide information and these are connected with the need for a company’s management to communicate with shareholders, their advisers and the wider public:

(a) **Conventional financial statements have limitations.**

They provide historical information, whereas managers and investors need to predict future performance. Financial statements only recognise monetary transactions and assets and liabilities that can be measured reliably at a monetary amount. Many organisations are successful as a result of their intangible assets: technical expertise; patents; software design; human and intellectual capital. Additional narrative reports enable management to explain a company’s future prospects and the significance of items that do not appear in the main financial statements.

(b) **Complexity and uncertainty**

Business operations are complex and affected by changes in the wider economic and political environment. Management needs to explain the risks and uncertainties that could affect a company’s future performance and position and the actions that it is taking to manage them.

(c) **Openness and transparency**

Full disclosure implies that management has nothing to hide and can be trusted. There is an argument that it is better to disclose ‘bad news’ than no information at all, particularly as disclosure provides an opportunity to explain the reasons for a poor performance and to describe the action that is being taken to ensure that future results will be better.
As we have seen, information about a company affects share prices. Voluntary disclosure gives management an opportunity to control the supply of information and to manage its impact on investors, analysts and the wider public.

The efficient markets hypothesis suggests that, to some extent, share prices will reflect all available information. Management cannot attempt to mislead the markets by ‘creative accounting’ or providing information which is biased or incomplete. While the efficient markets hypothesis has been shown to be flawed, there is some evidence that the markets reward disclosure and punish lack of information. A company’s reputation may be damaged if it fails to disclose bad news in a timely manner. Silence may lead the market to assume that a company’s situation is very much worse than it actually is.

**Question 2: Bad news**

Hemlock is a listed entity involved in the business of oil exploration, drilling and refining. The business has been consistently profitable, creating high returns for its international shareholders. In recent years, however, there has been an increase in environmental lobbying in the three countries in which it operates. Two years ago, an environmental group based in Overland started lobbying the government to take action against Hemlock for alleged destruction of valuable wildlife habitats in Overland’s protected wetlands and the displacement of the local population. At the time, the directors of Hemlock took legal advice, on the basis of which they assessed the risk of liability at less than 50%. A contingent liability of $500 million was noted in the financial statements to cover possible legal costs, compensation to displaced persons and reinstatement of the habitats, as well as fines.

Hemlock is currently preparing its financial statements for the year ended 28 February 20X5. Recent advice from the entity’s legal advisers has assessed that the risk of a successful action against Hemlock has increased, and must now be regarded as more likely than not to occur. The board of directors has met to discuss the issue. The directors accept that a provision of $500 million is required. The draft financial statements show that without the provision, operating profit margin and earnings per share both show a substantial increase on the previous year. However, recognising the provision will have an adverse effect on the financial statements for 20X5. Although the reported result for the year will still be a profit, both operating profit and earnings per share will be significantly lower than the comparative amounts for 20X4.

The directors are concerned about the potentially adverse effect on the share price, as Hemlock is actively engaged in a takeover bid that would involve a substantial share exchange. In addition, they feel that the public’s image of the entity is likely to be damaged. The Chief Executive makes the following suggestion:

‘Many oil businesses now publish an environmental and social report, and I think it may be time for us to do so. It would give us the opportunity to set the record straight about what we do to reduce pollution, and could help to deflect some of the public attention from us over this law suit. In any case, it would be a good public relations opportunity; we can use it to tell people about our equal opportunities program. We could probably pull something together to go out with this year’s annual report.’

**Required**

(a) Briefly discuss the directors’ view that the company’s share price and its reputation will be adversely affected as a result of recognising the provision in the financial statements for 20X5.

(b) Identify the advantages and disadvantages to Hemlock of adopting the Chief Executive’s proposal to publish an environmental and social report.

(The answer is at the end of the chapter)

### 2.3 Sources of company information

Information to shareholders comes from the following sources although this may vary in different jurisdictions:

- Annual financial report
- Chairman’s statement
- Directors’ report
- Corporate governance statement
Efficiency in capital markets and company reporting

• Corporate social responsibility report
• Auditors’ report
• Management Commentary.

We will look at most of these in more detail in the next section.

3 Content of company reports

3.1 Annual financial report

The annual financial report consists of the main financial statements together with notes and other explanatory material. The primary statements are cross-referenced to the notes.

IAS 1 Presentation of financial statements explains that the notes are normally presented in the following order:

• a statement of compliance with IFRSs;
• a summary of significant accounting policies adopted;
• supporting information for items presented in the primary statements in the order in which each statement and each line item is presented;
• other disclosures, including details of the company’s contingent liabilities and contractual commitments not recognised in the financial statements; and non-financial disclosures, such as the company’s policies for managing risk connected with its financial instruments.

The disclosures relating to accounting policies should include details of any significant judgments that management has made in applying the policies chosen, assumptions that it has made about the future and of other major sources of estimation uncertainty at the end of the reporting period.

3.2 Chairman’s statement

This is usually a fairly brief overview of the key achievements of the company in the period. The statement is voluntary and in theory it can contain whatever information the Chairman or the management wish. It may be used to provide users with important information about the future strategy of the company, but it normally emphasises the positive aspects of the company’s performance in the past year. It may include some summary financial information or non-financial measures (often presented as graphs or charts) or it may consist entirely of narrative content.

3.3 Directors’ report

In many countries, including Australia and the UK, the content of the Directors’ report is prescribed by companies legislation. In Australia, the Corporations Act 2011 (Cwth) requires that the report must include general information about the company and its activities, including:

(a) a review of its operations during the year and the results of those operations;
(b) details of any significant changes in the entity’s state of affairs during the year;
(c) the entity’s principal activities during the year and any significant changes in the nature of those activities during the year;
(d) details of any matter or circumstance that has arisen since the end of the year that has significantly affected, or may significantly affect the entity’s operations in future financial years;
(e) details of likely developments in the entity’s operations in future financial years and the expected results of those operations.

The directors’ report must also include:

(a) dividends paid during the year
(b) the name of each person who has been a director of the company during the year.

Public and/or listed companies may be required to disclose additional information about each director’s qualifications, experience or special responsibilities; their attendance at board and committee meetings during the year; and their interests in the company’s shares, debentures, or share options.
In many jurisdictions, including Australia, the directors’ report must also include detailed disclosures about directors’ remuneration, including performance related remuneration (for example, bonus payments dependent on the company’s results or movements in its share price). In some jurisdictions, this information may be provided in a separate report, or as part of corporate governance disclosures (see below).

Question 3: Purpose of the directors’ report

The only objective of general purpose financial reporting is to provide existing and potential investors, lenders and other creditors with information that is useful in making economic decisions.

In relation to the director’s report, is this statement true or false?

(The answer is at the end of the chapter)

3.4 Corporate governance statement

Corporate governance is the system by which companies are directed and controlled.

Definition

Corporate governance is the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It encompasses the mechanisms by which companies, and those in control, are held to account.

(Australian Stock Exchange)

The directors are responsible for the governance of their companies. Most listing authorities require companies to comply with codes of corporate governance as a condition of listing. A code of corporate governance requires the directors to set up a system of controls and procedures to ensure that the company is being run effectively for the benefit of the shareholders.

Listed companies must include a corporate governance statement in their annual report. Many listing authorities, including the Australian Stock Exchange (ASX) and the London Stock Exchange, have adopted the ‘if not, why not?’ approach, whereby companies are required to disclose the extent to which they have followed the recommendations or principles set out in the Code in the reporting period. Where companies have not followed all the recommendations, they must identify those that have not been followed and give reasons for not following them. Other listing authorities may require a different approach.

In practice the corporate governance statement includes descriptions of the roles and responsibilities of the directors, procedures put in place to maintain the independence of non-executive directors, relationships with external auditors, investors and other key stakeholders. It shows the members of the board who sit on the various committees, such as audit, remuneration and nomination committees. It also describes and explains the systems that the directors have put in place to manage risk, including the company’s internal control systems.

Case study: Corporate governance report

The ASX sets out eight fundamental principles of corporate governance:

1. Lay solid foundations for management and oversight
2. Structure the board to add value
3. Promote ethical and responsible decision-making
4. Safeguard integrity in financial reporting
5. Make timely and balanced disclosure
6. Respect the rights of shareholders
7. Recognise and manage risk
8. Remunerate fairly and responsibly

Below is an extract from the Corporate Governance Statement for the Qantas Group for the year ended 30 June 2010. The full report is some 6 pages long and covers each of the eight principles in turn.
Corporate Governance Statement
Continued

for the year ended 30 June 2010

THE BOARD IS STRUCTURED TO ADD VALUE

Qantas currently has ten Directors (see details on pages 10 and 11). Nine Directors are Independent Non-Executive Directors elected by shareholders. The Independent Non-Executive Directors are:

<table>
<thead>
<tr>
<th>Director</th>
<th>Year of Appointment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leigh Clifford (Chairman)</td>
<td>2007</td>
</tr>
<tr>
<td>Peter Cosgrove</td>
<td>2005</td>
</tr>
<tr>
<td>Particia Cross</td>
<td>2004</td>
</tr>
<tr>
<td>Richard Goodmanson</td>
<td>2008</td>
</tr>
<tr>
<td>Garry Hounsell</td>
<td>2005</td>
</tr>
<tr>
<td>Paul Rayner</td>
<td>2008</td>
</tr>
<tr>
<td>John Schubert</td>
<td>2000</td>
</tr>
<tr>
<td>James Strong</td>
<td>2006</td>
</tr>
<tr>
<td>Barbara Ward</td>
<td>2008</td>
</tr>
</tbody>
</table>

Independence

Independence Directors are those who have the ability to exercise their duties unfettered by any business or other relationship and are willing to express their opinions at the Board table free of concern about their position or the position of any third party. The Board does not believe it is possible to draft a list of criteria which are appropriate to characterise, in all circumstances, whether a Non-Executive Director is independent. It is the approach and attitude of each Non-Executive Director which is critical and this must be considered in relation to each Director while is critical and this must be considered in relation to each Director while taking into account all other relevant factors, which may include whether the Non-Executive Director:

- Is a substantial shareholder (within the definition of section 9 of the Corporation Act) of Qantas, or an officer of, or otherwise associated directly with, a substantial shareholder of Qantas
- Has, within the last three years, been employed in an executive capacity by the Qantas Group
- Has, within the last three years, been a principal of a material professional adviser or a material consultant to the Qantas Group or an employee materially associated with the service provided
- Is a material supplier or customer of the Qantas Group, or an officer of or otherwise associated directly or indirectly with a material supplier or customer
- Has any material contractual relationship with the Qantas Group other than as a Director
- Has served on the Board for a period which could materially interfere with the Director’s ability to act in the best interests of the Qantas Group (and it is neither possible nor appropriate to assign a fixed term to this criteria)
- Is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the Director’s ability to act in the best interest of Qantas

The Board Charter requires each Director to immediately disclose to the Board if they have any concerns about their independence.

All Independence No-Executive Directors bring an independent view to the consideration of Board issues.

Qantas believes the following materially thresholds are relevant when considering the independence of Non-Executive Directors:

- For Directors:
  - A relationship which accounts for more than 10 per cent of their gross income (other than Director’s fees paid by Qantas), or
  - When the relationship is with a firm, company or entity, in respect of which the Director (or any associate) has more than a 20 per cent shareholding if a private company or two per cent shareholding if a listed company

- For Qantas:
  - In respect of advisers or consultants—where fees paid exceed $2 million per annum
  - In respect of supplier—where goods or services purchased by the Qantas Group exceed $100 million per annum (other than banks, where materiality must be determined on a case basis), or
  - In respect of customers—where goods or services supplied by the Qantas Group exceed $100 million per annum

Qantas, as the principal Australian airline, has commercial relationships with most, if not all, major entities in Australia. As such, in determining whether a Non-Executive director is independent, simply being a non-executive director on the board of another entity is not, in itself, sufficient to affect independence.

Nevertheless, any Director on the board of another entity is ordinarily expected to excuse themselves during any meeting where that entity’s commercial relationship with Qantas is to be directly or indirectly discussed.

Qantas currently has one Executive Director Alan Joyce, who is not treated as independent.

Independent professional advice is available to the Directors if necessary, at the expense of Qantas.

At the 200 AGM, shareholder approved Qantas entering into Director Protection Deeds with each Director.

Nominations Committee

The Nominations Committee:

- Has four Members who are independent Non-Executive Directors
- Is chaired by Leigh Clifford
- Has a written Charter which is available in the Corporate Governance section on the Qantas website
- Meets as required to assist the Board in fulfilling its corporate governance responsibilities in regard to:
  - Board appointments, re-elections and performance
  - Director’s induction and continuing development
  - Committee Membership
  - Endorsement of Executive Management
  - Diversity obligations

The experience and qualifications of Members of the Nominations Committee are detailed on pages 10 and 11. Membership of and attendance at 2009/2010
3.5 Corporate social responsibility report

Most large listed entities present a corporate social responsibility report of some kind, either as part of their annual report, or as a stand-alone document. The corporate social responsibility report provides information about the way in which a company’s activities have affected the natural environment and the community in which it operates. It describes and explains the actions it has taken to safeguard the environment and to act in an ethical and socially responsible manner towards its employees and other people affected by its activities.

Corporate social responsibility reports may be called environmental, social or sustainability reports. Information about corporate social responsibility may also be included in the directors’ report (see above) or in the management commentary (see below).

Most jurisdictions now encourage companies to provide information and companies legislation may contain limited reporting requirements. In the UK, quoted companies must include information about the impact of the company’s business on the environment; the company’s employees; and information about social and community issues in the directors’ report. However, most corporate social responsibility reporting is voluntary. Although there are a number of published guidelines and codes of practice (of which the most important are the Sustainability Reporting Guidelines published by the Global Reporting Initiative (GRI)), there are no disclosure or reporting requirements within IFRS. Therefore companies can disclose whatever information they wish or as much or as little as they wish.

While some reports are mainly public relations exercises, many now provide useful information, including key performance measures, with comparatives for previous periods. Many companies now present reports that have been audited or accredited under the GRI or similar guidelines.

Case study: Sustainability report

Below is an extract from the 2010 Sustainability Report of Origin Energy, a company included in the Dow Jones Sustainability Asia Pacific Index and the FTSE 4 Good Index. This report is a separate stand-alone report, intended mainly for the general public (including potential customers) and includes photographs, diagrams, charts and a glossary. It reports the company’s progress against a series of 5 year objectives that were set in 2007.
Our Communities

The breadth of Origin’s business brings us into contact with a diverse range of communities. We engage with community representatives ranging from governments and media through to non-government organizations, local councils and community groups, and individuals.

In 2007, we set ourselves three objectives in relation to communities for the ensuing five years:

- To take all feasible steps to eliminate or minimize any adverse impact that our activities have on the environment;
- To reduce the greenhouse gas intensity of our energy production and distribution and non-producing assets; and
- To maintain community support and goodwill for the Company’s activities.

To deliver on these objectives, we laid out a series of 5-year strategies, which we report against in this section.

5-Year Strategies

1. Contribute to a policy and industry response to climate change that delivers an effective pricing regime for carbon.

In FY 2010, we engaged extensively in the public debate around how to deliver a sustainable long-term transition to a lower carbon economy. We continue to believe that in Australia’s deregulated energy markets, a carbon emissions trading scheme and action at the federal level on energy efficiency and distributed generation (to replace un-coordinated state programs) should be the core policies for delivering affordable long-term emissions reductions. In the coming year we will continue to pursue these priorities.

Origin was represented on a number of high level committees during the year, including the Australian Prime Minister’s Task Force on Energy Efficiency, and at a number of public speaking events. We worked with public servants where appropriate to share knowledge relevant to important policy issues.

Highlights for the year included the expansion of the New Zealand Emissions Trading Scheme to cover electricity and selected industrial sectors, and the introduction of the expanded Renewable Energy Target in Australia setting a goal that 20 percent of the country’s electricity be met from renewables by 2020.

Origin and our joint venture partner Geodynamics were the beneficiaries of an award by the federal government of $50 million under the government’s Renewable Energy Demonstration Program to help prove the long-term potential of unconventional power.

2. Reduce the greenhouse gas emissions intensity of our electricity supply chain to 10 per cent less than the National Electricity Market by 2020.

Total supply chain emissions for electricity supplied to Origin electricity Customers in FY 2010 was 2.6 per cent below the National Electricity Market (NEM) average. This improvement reflects a full year of output from Cullerin Range Wind Farm and the gas-fired power stations at Uranquidity and Quarantine. With a view to the longer term, we increased investment in renewable prospects through our partnership with Geodynamics (geothermal energy) and Micron Technology Inc (solar PV panel manufacture) and more than doubled our investments in exploration for new sources of gas.

With a full year of output from Darling Downs Power Station in FY 2011, which will be the largest combined cycle gas-fired power station in Australia, we expect accelerated progress towards our 2020 goal in the coming year, taking us to approximately 9 per cent the NEM average.

<table>
<thead>
<tr>
<th>Year</th>
<th>2020 Target (10%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>07</td>
<td>0.4%</td>
</tr>
<tr>
<td>08</td>
<td>0.3%</td>
</tr>
<tr>
<td>09</td>
<td>0.7%</td>
</tr>
<tr>
<td>10</td>
<td>2.6%</td>
</tr>
</tbody>
</table>

3. Reduce the greenhouse gas emissions intensity of our gas production by 15 per cent by 2012.

We are well on track to meet our 5-year target to reduce the greenhouse gas emissions intensity of our gas production by 15 per cent from 2007 levels. The emissions intensity of our gas production in 2007 was 11.0 kgCO₂e/MJ. This year it was 7.99 kgCO₂e/MJ, which is a 27.4 per cent reduction on 2007 levels.

Over the coming year, we do not anticipate a significant increase in the greenhouse gas emissions intensity of our gas production despite a full year of production from higher-intensity fields at Kupe and Otway. This is due to significant expansion of our CSG production, which has a very low carbon dioxide content. While production these changes will likely result in a slight net increase in intensity over the coming year, we remain on target for our 2012 goal.

<table>
<thead>
<tr>
<th>Year</th>
<th>2020 Target (15%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>07</td>
<td>0.0%</td>
</tr>
<tr>
<td>08</td>
<td>9.1%</td>
</tr>
<tr>
<td>09</td>
<td>15.0%</td>
</tr>
<tr>
<td>10</td>
<td>27.4%</td>
</tr>
</tbody>
</table>

Greenhouse gas intensity of our electricity supply chain below NEM

Greenhouse gas intensity of our electricity supply chain below NEM
4. Reduce or offset all greenhouse gas emission from our non-energy producing sites.

We will continue to honour our target to offset 100 per cent of greenhouse gas emissions from our non-energy producing sites, such as emissions due to cars and air travel. This will be met 20 per cent with GreenPower and 80 per cent through the use of carbon offsets.

5. Identify opportunities for the reduction and re-use of waste

Our priority focus in the area of waste has been on CSG water produced in our CSG operations. We delivered against the actions to which we committed in last year’s report by developing an industry-leading cumulative impact model for CSG groundwater and conducting a large scale trial on the use of CSG water to develop a plantation of biofuel-potential pongamia trees.

Over the next 12 months, we will continue to discuss with government how our cumulative impact modelling might be used to help government and industry plan for sustainable development of the CSG fields in the years ahead. The decision whether to increase the scale of our pongamia plantations will be affected by government’s decisions about its preferences for dealing with water.

We will continue to work intensively with government to help develop frameworks that will lead to long-term sustainable development of Queensland’s CSG fields. We continue to undertake industry-leading research on CSG water, which we will share not only with government but with the public and industry to help the community make informed choices about the way industry is guided and regulated.

6. Rehabilitate or look for opportunities to offset land we have disturbed.

In FY 2010, we disturbed 389 hectares of land and rehabilitated 237 hectares, achieving a ratio of rehabilitated land to newly disturbed land of approximately 65 per cent. We worked extensively with the Queensland Government and other industry players to put in place sustainable standards for biodiversity offsets for the emerging CSG to LNG industry. We also expanded use of the new Envirovibe technology to conduct seismic testing when exploring in CSG fields.

In FY 2011, we expect to maintain a high rate of land rehabilitation relative to disturbance, maintaining 65 per cent or better. We will continue to invest in better understanding and managing the impacts of our CSG operations on disturbed land.

7. Actively consult with the community at all locations where Origin has a material impact.

Origin invested substantially during the year in making ourselves more present and available in the local communities around our major operations.

Our consultation process around the proposed Stockyard Hill Wind Farm is described on page 16. An overview of our comprehensive consultation program with our CSG communities in Queensland for the Australia Pacific LNG project is available in volume 2, Chapter 2 “Stakeholder Engagement” at http://www.aplng.com.au/esr.

We increased our presence in local communities, by putting in place people dedicated to local community consultation at Uranquinty, Mt Stuart and Darling Downs power station, the Cullerin Range Wind Farm, and our projects at Mortlake, Lexton, Stockyard Hill and Yass. This complements our existing presence at Kupe and in the south central Queensland gas fields around our Australia Pacific LNG project. We also appointed a national coordinator to augment the role of our regional community advisers. In addition, local shopfronts were established at Mortlake and for Australia Pacific LNG at Gladstone, Roma, Chinchilla and Miles.

We reached out in particular to the people of Mortlake, attracting over 1,000 people to an Open Day held in late 2009, and were engaged at length with a small sector of the community around the Uranquinty Power Station.

We also have community reference groups associated with our Mortlake project, BassGas, Otway, Cullerin Range Wind Farm and at our Townsville operations. These groups formalise ongoing two-way communication between Origin and the communities in which we operate and, at a very practical level, provide advice in awarding our community grants. In nearly all cases our representatives were recruited from the local community.

8. Achieve positive community relationships through regular, open and transparent communication with host communities.

Not everyone will agree with the decisions and trade-offs we make on major projects, but we care what our communities think, and are committed to listening to different points of view and to learning from what we hear. We are committed to making decisions transparently.

In FY 2010, we received 14 complaints from members of local communities, five fewer than in FY 2009. Most related to noise from operations or construction. Additional complaints were received regarding vehicle use at our New Zealand operations, odour related to LPG operations and concerns regarding site access from landowners.

We also increased over the last year our efforts at measuring whether we are undertaking major projects. Quarterly survey data was collected throughout our Queensland CSG fields and the area around the Darling Downs Power Station.

At a more general community level, we took part very actively in the public discussions over carbon pricing and rising gas and electricity prices. We put information into the public domain in relation to each of these topics, which was reflected extensively in national and state media.

You may like to compare this report with that of Newcrest Mining Limited www.newcrest.com.au.

Newcrest Mining reports under the GRI Sustainability Reporting Guidelines, which are extremely detailed and cover three areas: Economic Performance, Environmental Performance and Social Performance. The full report is 78 pages long and probably intended to be read mainly by corporate investors and industry experts.

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3.6 Auditors’ report

The auditors’ report sets out the auditors’ opinion of the financial statements. It states whether the financial statements show a true and fair view / fair presentation of the financial performance and financial position of the entity. The exact wording of the report is normally set out in auditing standards and guidelines.

Case study: Auditors’ report

The auditors’ report on the financial statements of Woolworths Limited for the 52 weeks ended 27 June 2010 is reproduced below.


We have audited the accompanying financial report of Woolworths Limited (the company), which comprises the balance sheet as at 27 June 2010, and the income statement, the statement of comprehensive income, the cash flow statement and the statement of changes in equity for the 52 weeks ended on that date, notes comprising a summary of significant accounting policies and other explanatory information, and the directors’ declaration of the consolidated entity comprising the company and the entities it controlled at the period end or from time to time during the financial period as set out on pages 78 to 160.

Directors’ Responsibility for the Financial Report

The directors of the company are responsible for the preparation and fair presentation of the financial report in accordance with Australian Accounting Standards (including the Australian Accounting Interpretations) and the Corporations Act 2001. This responsibility includes establishing and maintaining internal control relevant to the preparation and fair presentation of the financial report that is free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances. In Note 1, the directors also state, in accordance with Accounting Standard AASB 101 Presentation of Financial Statements, that compliance with the Australian equivalents to International Financial Reporting Standards ensures that the financial report, comprising the financial statements and notes complies with International Financial Reporting Standards.

Auditor’s Responsibility

Our responsibility is to express an opinion on the financial report based on our audit. We conducted our audit in accordance with Australian Auditing Standards. These Auditing Standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether the financial report is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor’s judgement, including the assessment of the risks of material misstatement of the financial report, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial report in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Auditor’s Independence Declaration

In conducting our audit, we have complied with the independence requirements of the Corporations Act 2001.

Auditor’s Opinion

In our opinion:

(a) the financial report of Woolworths Limited is in accordance with the Corporations Act 2001, including:

(i) giving a true and fair view of the company’s and consolidated entity’s financial position as at 27 June 2010 and of their performance for the 52 weeks ended on that date; and
(ii) complying with Australian Accounting Standards (including the Australian Accounting Interpretations) and the Corporations Regulations 2001; and

(b) the financial statements also complies with International Financial Reporting Standards as disclosed in Note 1.

Deloitte Touche Tohmatsu

3.7 Management commentary

Definition

A management commentary is a narrative report that relates to financial statements that have been prepared in accordance with IFRSs. Management commentary provides users with historical explanations of the amounts presented in the financial statements, specifically the entity’s financial position, financial performance and cash flows. It also provides commentary on an entity’s prospects and other information not presented in the financial statements. Management commentary also serves as a basis for understanding management’s objectives and its strategies for achieving those objectives.

(IFRS Practice Statement: Management Commentary)

Most listed companies present a management commentary of some kind. Although this is not required by IFRS or normally by companies legislation, it may be required by listing authorities and is generally regarded as best practice. A management commentary is sometimes called an Operating and Financial Review or a Management Discussion and Analysis.

The purpose of a management commentary is to provide users with information that helps them place the related financial statements in context. It explains management’s view on not only what has happened, but also why management believes it has happened and what management believes the implications are for the entity’s future.

The IASB has recently issued a Practice Statement that sets out general principles that should be followed when preparing management commentary and elements that should be included in it, but compliance is not mandatory. The Practice Statement does not prescribe the form and content of the report in detail because this will depend on the nature of the entity’s business and its circumstances.

The principles are that management commentary should:

• Provide management’s view of the entity’s performance, position and progress
• Supplement and complement the information in the financial statements
• Include forward-looking information

A management commentary should include information that is essential to an understanding of:

(a) the nature of the business;
(b) management’s objectives and strategies for meeting those objectives;
(c) the entity’s most significant resources, risks and relationships;
(d) the results of operations and prospects; and
(e) the critical performance measures and indicators that management uses to evaluate the entity’s performance against stated objectives (sometimes called Key Performance Indicators or KPIs).

This is an unqualified, or ‘clean’ audit report. The financial statements give a true and fair view.

Qualified audit reports are rare. Because of the potential damage to a company’s reputation, management and auditors normally resolve any disagreements. The financial statements are adjusted if this is necessary. A qualified audit opinion states that the financial statements give a true and fair view except for a particular matter or matters. Where problems are fundamental, the auditor can either disclaim an opinion or give an adverse opinion.
Case study: Bunnings (a Wesfarmers’ business)

Below is an extract from the 2010 Annual Report of Wesfarmers Limited. The Annual Report includes a Finance Director’s Review, a commentary on the group’s results, cash flow, balance sheet (financial position), debt management, equity management, dividend policy, risk management and internal control and assurance. The Annual Report then considers each of the company’s main operations in turn using the same headings for each: the business (a brief description); results; year in brief; business sustainability; and outlook.

Home Improvement and Office Supplies

Bunnings and Officeworks – leading retailers in home improvement and office supplies.

Home Improvement

The business

Bunnings is the leading retailer of home improvement and outdoor living products in Australia and New Zealand and a major supplier of building materials.

Operating from a network of large warehouse stores, smaller format stores, trade centres and frame and truss manufacturing sites, Bunnings caters for do-it-yourself customers as well as builders and contractors.

Strategy

Bunnings provides its customers with the widest range of home improvement and outdoor living products and is committed to delivering the best service and lowest prices every day. It sets out to attract high quality employees and to provide them with a safe and rewarding working environment.

Bunnings continues to develop and improve its store network through ongoing investment in existing outlets, remerchandising initiatives and new store openings. Bunnings is developing a network of trade centres to support major builder customers, in conjunction with a network of frame and truss manufacturing plants, to ensure a full service offer is provided.

Results

Operating revenue from the Bunnings home improvement business increased by 9.7 per cent to $6.4 billion for the full-year, with trading revenue increasing by 10.4 per cent. Earnings before interest and tax grew 10.5 per cent to $728 million.

Cash sales growth in Bunnings of 10.3 per cent was achieved during the year, with underlying store-on-store cash sales increasing by 7.3 per cent, reflecting continued strong organic growth in the business. Trade sales were 10.8 per cent higher than the comparative period.

Pleasing results were achieved in all Australian states and New Zealand, across all product ranges, driven by good execution of merchandising and operational strategies.

Year in brief

During the year, 11 warehouse stores, two smaller format stores and nine trade centres were opened. At year-end there were 184 warehouse, 58 smaller format stores and 29 trade centres operating across Australia and New Zealand. Investment in bringing current merchandising standards into older parts of the network continued, together with category specific upgrade work across the whole network.

Business sustainability

Bunnings’ commitment to environmental responsibility and supporting the community continued throughout the year. Work continued during the year to reduce energy use in stores and waste to landfill. Water savings were achieved through continued rainwater collection and innovative nursery irrigation techniques.

Over the year, Bunnings supported more than 33,000 community activities through community group sausage sizzles, hands on do-it-yourself projects and renovations, local fundraising activities. Support included active team member engagement, product contributions and financial assistance. This involvement helped raise and contribute more than $20.1 million to local, regional and national charities and community organizations across Australia and New Zealand.

Safety continues to receive a very high profile in the business through the B.S.A.F.E. program, with the rolling 12 month All Injuries Frequency Rate improving to 35.9 from 42.8.

Outlook

The business is well positioned for continued sales growth. The strategic focus in the business remains on five growth drivers: service; category expansion; network expansion; commercial opportunities in-store and via trade centres and achieving lower costs of doing business to underpin the provision of more value to customers.
Key chapter points

- The theory behind share price movements can be explained by the three forms of the **efficient market hypothesis**:
  - **Weak form efficiency** implies that prices reflect all relevant information about past price movements and their implications
  - **Semi-strong form efficiency** implies that prices reflect past price movements and publicly available knowledge
  - **Strong form efficiency** implies that prices reflect past price movements, publicly available knowledge and inside knowledge

- Information available to shareholders comes from the following sources although this may vary in different jurisdictions:
  - Annual financial report
  - Chairman’s statement
  - Directors’ report
  - Corporate governance statement
  - Corporate social responsibility report
  - Auditor’s report
  - Management commentary
Quick revision questions

1. What is meant by 'allocative efficiency', in the context of the efficient market hypothesis?
   A. financial markets allow funds to be directed towards firms that make the most productive use of them
   B. financial markets have transaction costs that are kept as low as possible
   C. financial markets have the ability to price stocks and shares fairly and quickly
   D. financial markets do not react to new information with changes in share prices

2. What does the following statement define?
   'Financial markets have the ability to price stocks and shares fairly and quickly.'
   A. allocative efficiency
   B. operational efficiency
   C. information processing efficiency
   D. weak-form efficiency

3. What information does the semi-strong form of market efficiency reflect?
   I. No information
   II. All information in past share prices
   III. All publicly available information
   IV. Specialist and experts' insider knowledge
   A. I only
   B. I and IV only
   C. II and III only
   D. II, III and IV only

4. What information does the strong form of market efficiency reflect?
   I. No information
   II. All information in past share price
   III. All publicly available information
   IV. Specialist and experts' insider knowledge
   A. I only
   B. I and III only
   C. I, II and IV only
   D. II, III and IV only

5. X Co has just released information about its proposed dividend of 5c per share (previous year 6c per share). Which of the following statements could explain the effect on X Co’s share price?
   A. the market was not expecting a reduced dividend so X Co’s share price should increase
   B. the market was expecting an increase in dividend so X Co’s share price should increase
   C. the market was expecting the dividend to be cut to 4c per share so X Co’s share price should show a moderate increase
   D. the market was not expecting a reduced dividend so X Co’s share price should remain constant
Answers to quick revision questions

1. A If financial markets allow funds to be directed towards companies which make the most productive use of them, then there is allocative efficiency in these markets.

2. C Allocative efficiency is explained above; financial markets have operational efficiency if transaction costs are kept as low as possible; weak-form efficiency implies that prices reflect all relevant information about past price movements and their implications.

3. C Semi-strong form efficiency implies that prices reflect past price movements and publicly available knowledge.

4. D Strong form efficiency implies that prices reflect past price movements, publicly available knowledge and inside knowledge.

5. C A dividend decrease is usually viewed by markets to be bad news, but it may be that the market will react to the difference between the actual dividend payments and the market’s expectations of the level of dividend. If the market was expecting an increase in dividend, or at the very least, not expecting a reduction in dividend, the share price would decrease on announcement of the reduced dividend, therefore A, B and D are incorrect.
1. According to the efficient market hypothesis there are three forms – weak, semi-strong and strong.

**Weak form**

Under the weak form hypothesis of market efficiency, share prices reflect all available information about past changes in the share price.

Since new information arrives unexpectedly, changes in share prices should occur in a random fashion. If it is correct, then using technical analysis to study past share price movements will not give anyone an advantage, because the information they use to predict share prices is already reflected in the share price.

**Semi-strong form**

If a stock market displays semi-strong efficiency, current share prices reflect both:

- All relevant information about past price movements and their implications, and
- All knowledge which is available publicly.

This means that individuals cannot ‘beat the market’ by reading the newspapers or annual reports, since the information contained in these will be reflected in the share price.

**Strong form**

If a stock market displays a strong form of efficiency, share prices reflect all information whether publicly available or not:

- From past price changes
- From public knowledge or anticipation
- From specialists’ or experts’ insider knowledge (e.g. investment managers).

2. (a) The directors are probably justified in fearing that the fall in operating profit will have an adverse effect on the share price in the short term, particularly as investors often look at earnings per share in isolation.

However, the company is still profitable. A contingent liability for the same amount was disclosed two years ago, so analysts will have had some warning that this situation might arise. It should also be clear that this is a ‘one off’ expense and that otherwise the company has performed strongly during the year. In the medium term the company’s share price will probably recover. There may be advantages in getting the bad news over quickly; analysts may feel that it is better to be aware of the worst case scenario.

(b) Advantages of publishing an environmental and social report:

- It would probably enhance the company’s reputation. Hemlock would appear to be responding to the information needs of all its stakeholders, not just providers of capital.
- Ethical and ‘green’ issues are becoming increasingly important to customers, suppliers, employees and the general public. If Hemlock is genuinely able to demonstrate that it is aware of its corporate social responsibilities this may improve its performance and share price in the longer term.

Disadvantages of publishing an environmental and social report:

- If the report is to be taken seriously and to reflect well upon the company it must not be perceived as a public relations exercise but a genuine attempt to provide useful information. It must be at least as good as those of the company’s competitors, otherwise it may damage Hemlock’s reputation, rather than enhance it.
- The report will be time consuming and costly to prepare. It will not be possible to ‘pull something together’. To be credible, the report should include performance indicators.
and these should remain the same from year to year, even if performance declines in those areas.

3 The statement is false. The directors’ report does provide useful information for making economic decisions, but that is not its only purpose. The information disclosed helps shareholders to assess the stewardship of management. Investors need to know how efficiently and effectively the directors have discharged their responsibility to use the entity’s resources to generate returns. In particular, the information about directors’ remuneration is largely provided so that shareholders will be aware of any attempts by the directors to reward themselves excessively.
Revision questions
Chapter 1

1 Which of the following describes 'limited liability'?
A a business is not liable to its creditors if it cannot meet its debts
B the owners of a business are only liable if the business fails to the extent of the amount they have agreed to invest
C if the business fails there is a limit to the amount that has to be paid to creditors
D in a partnership each partner is only liable for the amount of capital paid into the business

2 Consider the following statements:
I The financial accountant will be more concerned with historic information than future plans
II The financial accountant will be concerned about planning, control and decision making within the business.
Which of the statements are correct?
A I only
B II only
C both statements
D neither statement

3 What is meant by stewardship?
A the relationship between the partners in a partnership
B a sole trader employing additional workers for his business
C the fact that shareholders in a company have limited liability
D the management of a company by the directors rather than the shareholders

4 A department in a business has controls to ensure that only authorised payments are made, that no invoice ever gets paid twice and that expenses are coded to the correct accounts. Which business department will this be?
A marketing department
B sales department
C purchasing department
D accounts department

5 Which of the following is one of the roles of the credit controller?
A to find the best supplier in terms of price, quality and delivery
B to determine whether cash discounts from suppliers should be accepted
C to authorise materials requisitions
D to authorise sales on credit to a customer

6 You are an accountant who is about to write a cheque in order to pay a credit supplier. What is the correct sequence of events that you would follow?
A check invoice calculations, write cheque, check invoice to purchase order, check invoice to goods received note
B write cheque, check invoice to goods received note, check invoice calculations, check invoice to purchase order
C write cheque, check invoice to purchase order, check invoice to goods received note, check invoice calculations
D check invoice to purchase order, check invoice to goods received note, check invoice calculations, write cheque
Chapter 2

1. What is the name of the general principles document produced by the IASB which provides the conceptual framework for the setting of International accounting standards?

   A. Conceptual Framework for Setting Accounting Standards
   B. Statement of principles for Financial Reporting
   C. Conceptual Framework for Financial Reporting
   D. Statement of Concepts for the Preparation of Financial Statements

2. Consider the following two statements:
   I. The US FASB operates a principles-based system of setting accounting standards
   II. The IASB operates a rules-based system of setting accounting standards

   Which of these statements are correct?

   A. I only
   B. II only
   C. both statements
   D. neither statement

3. How many members does the IASB have?

   A. 2
   B. 10
   C. 12
   D. 15

4. Which bodies does the IFRS Foundation oversee?

   A. IASB and IFRSIC
   B. IFRSAC, IASB and IFRSIC
   C. IFRSIC and IFRSAC
   D. IASB and the Monitoring Board

5. Which of the following is not a role of the IFRS Advisory Council?

   A. to issue International Financial Reporting Standards
   B. to consult on all major IASB projects
   C. to advise on the prioritisation of the work of the IASB
   D. to comment on the implications of the work of the IASB on users of financial statements

6. In which country is the Financial Accounting Standards Board based?

   A. UK
   B. France
   C. US
   D. Germany
Chapter 3

1. Which of the following is a disadvantage of having a conceptual framework?
   A. there are a variety of accounting situations which mean flexibility in the accounting approach is needed
   B. there may be a need for a variety of accounting standards, each produced for a different purpose
   C. the framework does not simplify the preparation and implementation of standards
   D. a framework encourages standardised accounting practice

2. Which of the following is not a chapter in the IASB’s Conceptual Framework?
   A. underlying assumption
   B. concepts and conventions
   C. the elements of financial statements
   D. recognition of the elements of financial statements

3. Consider the following statements:
   I. One of the purposes of the IASB’s Conceptual Framework is to allow alternative accounting treatments in accounting standards.
   II. One of the purposes of the IASB’s Conceptual Framework is to assist auditors in forming an opinion as to whether financial statements have complied with IFRS.

Which of the statements is correct?
   A. I only
   B. II only
   C. both statements
   D. neither statement

4. What is shown by an entity’s economic resources and the claims against it?
   A. its financial performance
   B. its financial position
   C. its operations
   D. its ownership interest

5. Why is information about a reporting entity’s net cash flows helpful to users?
   A. it helps them to assess the stewardship of management
   B. it helps them to understand the claims against the entity
   C. it helps them to predict future cash flows
   D. it helps them to understand the entity’s financial performance

6. Consider the following statements:
   I. Liquidity relates to the ability to repay short-term financial commitments
   II. Solvency relates to the ability to repay longer-term commitments

Which of the statements is correct?
   A. I only
   B. II only
   C. both statements
   D. neither statement
Chapter 4

1 In special circumstances a company may not adhere to the requirements of an International Accounting Standard. What is this known as?
   A unfair presentation
   B true but unfair presentation
   C true and fair override
   D fair presentation override

2 Consider the following statements:
   I Accounting standards are applied to all items in the financial statements
   II Accounting standards are not retrospective

Which statements are correct?
   A I only
   B II only
   C both statements
   D neither statement

3 Where would a definition of accounting policies be found?
   A Conceptual Framework for Financial Reporting
   B IAS 1
   C IAS 8
   D IFRS 1

4 When a non-current asset is being depreciated, decisions will need to be taken about the method of depreciation and the useful life over which the asset is depreciated. Are these two factors accounting policies or accounting estimates?

<table>
<thead>
<tr>
<th>Method of depreciation</th>
<th>Length of useful life</th>
</tr>
</thead>
<tbody>
<tr>
<td>A accounting policy</td>
<td>accounting policy</td>
</tr>
<tr>
<td>B accounting policy</td>
<td>accounting estimate</td>
</tr>
<tr>
<td>C accounting estimate</td>
<td>accounting policy</td>
</tr>
<tr>
<td>D accounting estimate</td>
<td>accounting estimate</td>
</tr>
</tbody>
</table>

5 Consider the following statements:
   I Any change in measurement basis is regarded as a change of accounting policy and must be disclosed
   II Any change in estimation technique is not a change of accounting policy and does not need to be disclosed

Which statements are correct?
   A I only
   B II only
   C both statements
   D neither statement

6 Which of the following qualities are required to achieve a faithful representation of economic phenomena?
   I Comparability
   II Neutrality
   III Verifiability
   IV Completeness
   V Error free

   A I, II and IV only
   B II, III and V only
   C II, IV and V only
   D III, IV and V only
Chapter 5

1 Which of the following is the correct definition of equity?
   A the residual interest in the assets of the entity after deducting all its liabilities
   B a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits
   C a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity
   D a present obligation arising from past events from which future economic benefits are expected to flow to the entity

2 Consider the following statements:
   I A provision is a liability for which the amount is an estimate
   II A provision should not be recognised in the financial statements

   Which of the statements are correct?
   A I only
   B II only
   C both statements
   D neither statement

3 Consider the following statements:
   I Gains from the sale of non-current assets are not recognised in the income statement
   II Gains from revaluation of non-current assets are recognised in profit or loss

   Which of the statements is correct?
   A I only
   B II only
   C both statements
   D neither statement

4 What is the definition of materiality?
   A information which will be of particular significance to the managers of a business
   B information which will be of particular significance to the owners of a business
   C information whose omission or misstatement could influence decisions that users make on the basis of financial information.
   D information which has a large monetary value compared to the revenue of the business

5 Which of the following would be included in the working capital of a business?
   A receivables, bank loan, payables, inventory
   B payables, receivables, inventory, cash at bank
   C inventory, equity, cash at bank, receivables
   D inventory, bank loan, cash at bank, prepayments

6 Which of the following would appear in the statement of financial position as a current liability?
   A prepayments of expenses
   B employee wages
   C sales tax owing
   D revaluation surplus on a non-current asset
Chapter 6

1. Consider the following statements:
   I. The measurement of items in the financial statements only affects the statement of financial position
   II. The measurement of items in the financial statements is concerned with attributing a monetary value to those items

   Which statements are correct?
   A. I only
   B. II only
   C. both statements
   D. neither statement

2. What type of cost does the following definition describe?
   'Assets are carried at the amount of cash or cash equivalents that that could currently be obtained by selling the asset in an orderly disposal.'
   A. historical cost
   B. realisable value
   C. present value
   D. current cost

3. What does the following describe?
   'A current estimate of the present discounted value of the future net cash flows in the normal course of business.'
   A. realisable value
   B. present value
   C. settlement value
   D. historical value

4. What is one of the main advantages of using historical cost as a measurement basis?
   A. it is a reasonable estimate
   B. it is subjective
   C. it can use a formula for calculation
   D. it is objective

5. Which of following does this definition describe?
   'The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction'.
   A. residual value
   B. fair value
   C. current value
   D. economic value

6. What is meant by modified historical cost?
   A. assets valued at cost but liabilities valued at current value
   B. assets valued at current value but liabilities valued at cost
   C. non-current assets and non-current liabilities valued at valuation rather than cost
   D. non-current assets valued at valuation rather than cost
Chapter 7

1 Consider the following statements:
   I The use of a conceptual framework and accounting standards based on that framework would be an example of positive accounting theory
   II An attempt to predict accounting behaviour by observing what actually happens and applying this to particular situations is an example of normative accounting theory

Which statements are correct?
A I only
B II only
C both statements
D neither statement

2 Which type of capital maintenance concept is described by the following statement?
   'Capital is looked at as the capacity to maintain a level of assets'.
A proprietary capital maintenance
B equity capital maintenance
C financial capital maintenance
D operating capital maintenance

3 Consider the following statements:
   I Financial capital maintenance profit is the increase in nominal money capital over the period
   II Operating or physical capital maintenance profit is the increase in the physical productive capacity over the period

Which of the statements is correct?
A I only
B II only
C both statements
D neither statement

4 Which of the following is correct?
A financial capital maintenance is the concept used in current cost accounting
B operating capital maintenance is the concept used in current purchasing power accounting
C current cost accounting is based upon the use of general price inflation
D current purchasing power accounting is based upon the use of general price inflation

5 Consider the following statements:
   I In a time of rising prices borrowers benefit
   II Under current purchasing power accounting monetary items are restated to take into account the effect of general price inflation

Are these statements true or false?

<table>
<thead>
<tr>
<th>Statement I</th>
<th>Statement II</th>
</tr>
</thead>
<tbody>
<tr>
<td>true</td>
<td>true</td>
</tr>
<tr>
<td>false</td>
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<tr>
<td>false</td>
<td>true</td>
</tr>
<tr>
<td>false</td>
<td>false</td>
</tr>
</tbody>
</table>

6 Deprival value is defined as:
A the lower of net realisable value and the higher of net replacement cost and economic value
B the higher of net realisable value and the lower of net replacement cost and economic value
C the higher of net replacement cost and the lower of net realisable value and economic value
D the lower of net replacement cost and the higher of net realisable value and economic value
Chapter 8

1 Which of the following does not accord with the duties of an agent?
   A an unpaid agent is not bound to carry out his agreed duties
   B an agent must obey instructions even if asked to perform an illegal act
   C an agent may delegate his duties in a few special circumstances
   D an agent's own interests must not conflict with those of the principal

2 Consider the following statements:
   I A management buy-in occurs when existing managers purchase the business
   II In a share option scheme, employees are given a number of share options, each of which gives
      the holder the right after a certain date to subscribe for shares in the company at a fixed
      price
Which of the statements are correct?
   A I only
   B II only
   C both statements
   D neither statement

3 The preparation of the financial statements is the responsibility of
   A The Board of Directors
   B The Finance Director
   C The external auditors
   D The internal audit department

4 Consider the following statements:
   I The auditor's report must be disclosed in a set of financial statements.
   II The auditors' report confirms that the financial statements are correct
Which of the statements are correct?
   A I only
   B II only
   C both statements
   D neither statement

5 Which of the following is a non-mandatory disclosure in a listed company's annual report?
   A statement of financial position
   B corporate governance disclosures
   C social and environment report
   D statement of cash flows

6 Which of the following is not an advantage of voluntary disclosures by companies?
   A gives stakeholders a better idea of the environment within which the company is operating
   and how it is responding to that environment.
   B provision of additional information to other companies in the same business
   C it can be focused on future strategies and objectives
   D provides investors with further yardsticks to judge the performance of management
Chapter 9

1 What is meant by ‘operational efficiency’ in the context of the efficient market hypothesis?
A financial markets allow funds to be directed towards firms that make the most productive use of them
B financial markets have transaction costs that are kept as low as possible
C financial markets have the ability to price stocks and shares fairly and quickly
D financial markets do not react to new information with changes in share prices

2 Which of the following is not a requirement of an efficient capital market?
A no individual dominates the market
B transaction costs of buying and selling are not so high as to discourage trading significantly
C investors behave in an irrational manner
D there are low, or no, costs of acquiring information

3 Consider the following statements:
I If a company makes an investment with a positive net present value (NPV) price of its shares will rise
II If interest rates rise so will market prices
Which statements are correct?
A I only
B II only
C both statements
D neither statement

4 Which of the following statements are true about the weak form of market efficiency?
I Share prices reflect all available information about past changes in the share price
II Changes in share prices should occur in a random fashion
III Using technical analysis to study past share price movements should give an advantage and mean that higher returns can be earned
A I and II only
B I and III only
C II and III only
D I, II and III

5 Which of the following statements about the directors’ report are correct?
I It includes a review of the entity’s operations during the period
II It shows the members of the board who sit on the various committees, such as audit, remuneration and nomination committees
III It includes details of the individual directors on the board
A I and II only
B I and III only
C II and III only
D I, II and III

6 The purpose of the auditors’ report is to state that:
A the financial statements are correct
B the financial statements have been prepared by the auditor
C the business is a going concern
D the financial statements have been fairly presented
Answers to revision questions
Chapter 1

1  B  Limited liability refers to the liability of the owners of a company (i.e., the shareholders) to make good the debts of that company. Shareholders are liable only to the extent of the nominal value of their share capital. Where this has been paid up in full, there is no further liability.

2  A  Financial accountants are concerned with producing financial statements based on past performance; management accountants are concerned with forward-looking financial information used to plan and control a business.

3  D  Directors are responsible for the stewardship of a company on behalf of its shareholders i.e., they must run the company with the best interests of the shareholders in mind.

4  D  The accounts department.

5  D  The credit controller assesses the level of credit that should be given to customers and chases customers who do not make payments on time.

6  D  A cheque should not be written until the legitimacy and accuracy of the invoice have been checked.
Chapter 2


2  D  In each case the reverse is true: US accounting standards are rules-based and IFRS are principles-based.

3  D  This is set to increase to 16 by 2012.

4  B  The IFRS Foundation is the overseeing body for the IASB, IFRSIC and IFRSAC. The Monitoring Board serves as a mechanism for communication between capital markets authorities and the IFRS Foundation.

5  A  The IASB is responsible for issuing IFRS.

6  C  The FASB is the US standards setter.
Chapter 3

1. A conceptual framework is not sufficiently specific to deal adequately with all accounting topics; therefore standards are required for each of these different areas.

2. Concepts and conventions are contained within the Conceptual Framework, however this is not the title of a chapter.

3. One of the purposes of the Conceptual Framework is to enable the reduction of the number of alternative accounting treatments permitted by IFRS.

4. Its financial position (i.e., its assets and liabilities).

5. Information about a reporting entity’s cash flows during a period helps users assess the entity’s ability to generate future net cash inflows.

6. Liquidity deals with meeting short term obligations such as paying suppliers; solvency refers to the longer term financial health of a business.
Chapter 4

1. C A true and fair override arises where a company does not follow the requirements of an IFRS in order to achieve a true and fair presentation.

2. B Accounting standards do not apply to immaterial items.

3. C IAS 8 *Accounting policies, changes in accounting estimates and errors*

4. D The depreciation of non-current assets is an accounting policy; judgements in the application of this policy, including the useful life and residual value of an asset or method of depreciation, are accounting estimates.

5. C A change in accounting policy occurs if there has been a change in recognition, presentation or measurement basis. Such changes are applied retrospectively and disclosed. A change in estimation technique qualifies as a change in accounting estimate rather than accounting policy.

6. C A faithful representation is complete, neutral and free from error.
Chapter 5

1. A. B is the definition of a liability; C is the definition of an asset; D is a mixture of the definition of an asset and a liability.

2. D. A provision is a liability of uncertain timing and/or amount - the amount is not necessarily an estimate; it may be known and the uncertainty surrounds timing of the payment. Provisions are recognised in the financial statements when certain criteria are met.

3. D. A gain from the sale of a non-current asset is recognised in the income statement (as part of the profit or loss for the period) but the revaluation of a non-current asset is not recognised in profit or loss (it is recognised in equity and as part of other comprehensive income).

4. C. This is the definition contained within the Conceptual Framework.

5. B. The working capital of a business is its current assets and current liabilities.

6. C. Prepayments are current assets; employee wages are an expense; a revaluation surplus forms part of equity.
Chapter 6

1. B The measurement of items can also affect the statement of comprehensive income if there are increases / decreases in the measurement of assets and liabilities.

2. B Realisable value.

3. B Realisable value is the amount of cash or cash equivalents that could be obtained by selling an asset in an orderly disposal. Settlement value is the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business; historical value is the amount paid for an asset.

4. D Historical cost is objective in that it is equivalent to the amount paid to obtain an asset. No estimation nor cost formulae are required.

5. B This is the definition of fair value contained within a number of IFRS.

6. D Modified historical cost refers to the application of the revaluation model to certain assets.
Chapter 7

1 D The first statement relates to normative theory and the second to positive theory.

2 D Operating capital maintenance is based on the productive capacity of an entity, and therefore requires a maintained level of assets.

3 C Both statements are correct:
   • Financial capital maintenance profit is the increase in nominal money capital over the period
   • Operating or physical capital maintenance profit is the increase in the physical productive capacity over the period

4 D Statements A – C are all incorrect: operating capital maintenance is the concept in current cost accounting; financial capital maintenance, adjusted for inflation, is the concept in current purchasing power accounting; current cost accounting is based on specific price inflation.

5 B Under CPP accounting it is non-current assets which are restated for the effects of general price inflation.

6 D Deprival value is the lower of replacement cost or recoverable value. Recoverable value is the higher of sales value (net realisable value) and value in use (economic value).
Chapter 8

1. B  An agent is not required to carry out any instruction which is illegal.
2. B  A management buy-in is where external managers purchase the company.
3. A  The Board of Directors are responsible for preparing the financial statements.
4. A  The auditors’ report must be disclosed in the financial statements. It gives an opinion as to whether the financial show a true and fair view and are fairly presented.
5. C  A statement of financial position and statement of cash flows are required by IAS 1; corporate governance disclosures are required as part of compliance with listing rules.
6. B  B is not an advantage; competitors may use the information contained within such disclosures in order to gain advantages in the market.
Chapter 9

1 B Financial markets have operational efficiency if transaction costs are kept as low as possible. Transaction costs are kept low where there is open competition between brokers and other market participants.

2 C Investors are assumed to be rational.

3 A If interest rates rise then share prices will tend to fall as investors demand a higher return on their investment.

4 A Weak-form market efficiency assumes that the share price reflects all available information about the past; technical analysis would therefore not give an advantage.

5 B The details of the members of the various committees are detailed in the corporate governance report.

6 D Auditors do not prepare the financial statements. An auditor’s report does not indicate that financial statements are ‘correct’, although it does indicate that they are fairly presented and so free from material misstatement.
Before you begin

Answers and commentary
Knowledge of the main user groups of financial statements is important for any accountant:

- Shareholders and investors want to know how profitable their investment is.
- Management need financial information in order to run the company and make decisions.
- Suppliers want to know whether they will be paid and whether custom will continue into the future.
- Customers want to know whether they will have a continued supply.
- Lenders wish to know whether they will be repaid.
- Employees are interested in job security and whether they will be paid.
- The tax authorities are interested in profits for the purpose of calculating tax.
- The government is interested in companies' financial position from the perspective of the economy and national statistics.
- The public is interested in how companies affect the environment in which they operate.

Differences include:

<table>
<thead>
<tr>
<th>Financial accounts</th>
<th>Management accounts</th>
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</thead>
<tbody>
<tr>
<td>Prepared annually (although quarterly in some jurisdictions)</td>
<td>Normally prepared monthly or quarterly, often on a rolling basis</td>
</tr>
<tr>
<td>Provide historic information</td>
<td>Provide historic information and future budgets / forecasts</td>
</tr>
<tr>
<td>Are prepared in accordance with accounting regulations</td>
<td>Are not governed by any regulations</td>
</tr>
<tr>
<td>Contain summarised information</td>
<td>Contain detailed information</td>
</tr>
<tr>
<td>Prepared for external use</td>
<td>Prepared for internal use</td>
</tr>
</tbody>
</table>

Credit sales are recorded in the receivables ledger and in due course, in the general ledger.

Financial control procedures are required in a number of areas including:

- The authorisation of payroll
- The authorisation of purchases, including non-current assets
- Dual signatories for cheques
- Physical controls over petty cash
- The authorisation of credit controls for new customers
- The authorisation of new suppliers.

You should be able to identify many more areas where financial controls are required simply by thinking through the accounting system.

Advantages of a computerised system over a manual accounting system include:

- Faster processing time
- Less chance of computation errors arising
- Easier to make corrections or adjustments (as they carry through the system)
- Less physical space is needed to maintain records.
Chapter 2

1 GAAP is a term that all accountants should be familiar with.

GAAP is Generally Accepted Accounting Principles. It refers to all of the rules, from whatever source, that govern accounting in a particular jurisdiction. It may therefore include:

- National legislation
- Accounting standards
- Stock exchange requirements.

2 The correct answer is A. Regulations are not necessarily relevant to all organisations. It is therefore a disadvantage of a regulatory system that some companies are bound by regulations which are not relevant to them.

3 The IASB is the International Accounting Standards Board. Its objectives include:

- The development of high quality accounting standards
- The promotion of the use of those standards
- The convergence of international and national standards.

4 The IFRS Advisory Council was previously known as the Standards Advisory Council. The Council is made up of about 50 members who have an interest in international financial reporting. As such, the Council advises the IASB on agenda decisions, priorities in its work and the impact of standards in practice.

5 The IFRSIC is the International Financial Reporting Standards Interpretations Committee and was previously known as IFRIC. It assists the IASB in establishing and improving International Financial Reporting Standards, dealing with newly identified financial reporting issues not specifically addressed in IFRS, or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.

Knowledge of the regulatory bodies which contribute to the development of International Financial Reporting Standards is important.

6 The term ‘true and fair view’ is not defined in accounting standards. It is taken to mean that financial statements present fairly the position and performance of an entity. In many jurisdictions this is achieved through the application of IFRS, although in rare cases these may be departed from in order to achieve fair presentation.
Chapter 3

1. A conceptual framework is a statement of generally accepted theoretical principles which form the
   frame of reference for financial reporting.

2. Where there is no conceptual framework, the following problems may arise:
   - Standards are produced in a haphazard manner and ‘firefight’ problems which have developed.
     In other words they are reactive rather than proactive.
   - Contradictions and inconsistencies arise between standards.
   - Standards develop which are ‘rules-based’ rather than ‘principles-based’. These offer no
     flexibility and may result in incorrect reporting of the substance of transactions.

3. The correct answer is A. Additional objectives of the Conceptual Framework are to:
   - Assist preparers of accounts to apply IFRS.
   - Assist preparers of accounts when dealing with topics which are not the subject of an IFRS.
   - Assist users in interpreting financial statements.
   - Provide information about the approach to the formulation of IFRS.

4. The objective of general purpose financial reporting is to provide financial information about the
   reporting entity that is useful to existing and potential investors, lenders and other creditors in
   making decisions about providing resources to the entity.

5. Financial information should be prepared using accrual accounting because information about an
   entity’s economic resources and claims and changes in these during a period is more useful in
   assessing an entity’s past and future performance than information based solely on cash receipts and
   payments during that period.
Chapter 4

1. Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

   *This definition comes from IAS 8 and should be learnt.*

2. The correct answer is D. IAS 8 states that where management uses its judgment in developing and selecting an accounting policy the result should be information that is relevant and reliable. The Conceptual Framework states that the fundamental qualitative characteristics of useful financial information are relevance and faithful representation.

3. Financial information is relevant if it is capable of making a difference in the decisions made by users. Relevant financial information has predictive value, confirmatory value, or both.

4. **Going concern** is the assumption, when preparing a set of accounts, that an organisation will continue to operate for the foreseeable future (at least 12 months).

5. Substance over form is the principle that transactions are accounted for in accordance with their commercial substance rather than their legal form. Examples of its application include:
   - • Recognising an asset acquired under a finance lease as a non-current asset
   - • Producing consolidated accounts for groups of companies.

6. Barriers to the global harmonisation of accounting standards include:
   - • The different purpose of financial reporting in different countries
   - • Different legal systems
   - • An unwillingness of some countries to give up their own national standards
   - • Cultural differences
   - • The need for more basic standards for developing countries and more sophisticated standards for developed countries
   - • Unique circumstances such as hyperinflation in certain countries.

7. Advantages of the global harmonisation of accounting standards include:
   - • The ability of investors to compare potential investments from any country
   - • Easier access to cross border finance for multi national companies
   - • An easier consolidation process for multi national companies
   - • Easier calculation of tax liabilities for multi national companies
   - • The ability of developing countries with no national standards to adopt international standards rather than spending time and money developing their own.
Chapter 5

1 An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

2 A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

3 Equity is the residual interest in the assets of the entity after deducting all its liabilities. These definitions of elements of the financial statements are applied throughout numerous accounting standards. It is therefore important that you are familiar with them.

4 (a) The item must meet the definition of an element of the financial statements, and
(b) There must be a probable flow to or from the entity of any future economic benefit associated with the item, and
(c) The cost or value of the item must be capable of reliable measurement.

These recognition criteria are key, and you will find them repeated throughout a number of accounting standards.

5 The correct answer is B.

Assets and liabilities are presented broadly in order of liquidity only where this provides more relevant and reliable information.

An asset or liability settled in more than 12 months is classified as current if it is part of the normal operating cycle of the entity.
Chapter 6

1 Where the historical cost basis of measurement is applied:
   • Assets are recorded at the amount of cash paid or the fair value of consideration given to acquire them
   • Liabilities are recorded at the amount of proceeds received in exchange for the obligation.

2 Although the historical cost basis of measurement has a notable advantage in that it is objective, there are also a number of disadvantages, including:
   • The historical cost of an asset does not reflect its replacement value where there is inflation or prices have increased due to market conditions
   • Historical cost gives no indication of the realisable value of an asset
   • Comparisons over time are unrealistic
   • The cost of new non-current assets is aggregated together with the cost of some which may be very old, meaning that additions are not on a like for like basis
   • Historic cost does not capture the effect of important transactions and events, e.g. changes in the value of derivative financial instruments

3 The correct answer is C.

4 Fair value is ‘the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction’.
Chapter 7

1. A normative accounting theory is one which explains what should occur rather than what does.

2. Physical capital maintenance defines profit in terms of the increase in physical productive capacity over a period rather than in terms of the increase in monetary capital. Where physical capital is maintained, an entity is able to continue to operate at current levels of activity (having taken into account price inflation of raw materials and other costs).

3. Current purchasing power accounting measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

4. Current cost accounting requires that assets should be stated at their deprival value to the business. By taking account of changing prices, it therefore results in accounts which reflect the maintenance of the operating capability of a business.
Chapter 8

1 An agency relationship is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent.

2 The correct answer is C.

- An agent must keep in confidence what he knows of the principal’s affairs even after the relationship has ceased.
- If an agent receives commission from a third party, the contract between the principal and agent is always considered to be fraudulent.
- An unpaid agent is not bound to carry out his agreed duties.

3

<table>
<thead>
<tr>
<th>Principal</th>
<th>Agent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders</td>
<td>Directors</td>
</tr>
<tr>
<td>Directors</td>
<td>Auditors</td>
</tr>
<tr>
<td>Directors</td>
<td>Employees</td>
</tr>
</tbody>
</table>

4 A statement of financial position
A statement of comprehensive income (in one or two statements)
A statement of cash flows
A statement of changes in equity
Notes to the financial statements.

You should ensure that you know which parts of the financial statements are mandatory and which are non-mandatory.

5 Corporate governance disclosures are important as they explain to the shareholders of an entity what steps the directors are taking to ensure that the company is run properly.

6 The advantages of disclosing non-mandatory information include:
- enabling shareholders to better understand the company and its environment
- providing shareholders with more information on which to base an assessment of the stewardship of the directors
- allowing shareholders to access the information which interests them.
Chapter 9

1 The efficient market hypothesis is the hypothesis that the stock market reacts immediately to all the information that is available. Thus a long term investor cannot obtain higher than average returns from a well diversified share portfolio.

2 Weak form efficiency implies that share prices reflect all available information about past changes in the share price, and future prices cannot be predicted.
   Strong form efficiency implies that share prices reflect all public and non-public information, including information from past price changes, from public knowledge and from experts' inside information. Therefore no one can earn excess returns.

3 Depending on the jurisdiction within which they are, shareholders have access to a number of sources of company information including:
   - The financial statements
   - The chairman's statement
   - The directors' report
   - A corporate governance statement
   - A corporate social responsibility report (which may contain an environmental report)
   - The auditors' report
   - Press releases.
   - Management commentary

   These sources of information may differ from jurisdiction to jurisdiction.

4 A corporate governance report details how the directors of an entity have complied with corporate governance regulations during the financial year. In particular, it may include information on the independence of non-executive directors, internal control systems, relationships with key stakeholders and the members of audit and remuneration committees.

5 A corporate social responsibility report explains how an entity has addressed social issues such as the employment of disabled people or support of charities and environmental concerns such as levels of emissions.

6 The chairman's statement is a summary of the achievements of an entity in a period.

**Ensure that you know the contents of the supplementary information found in a set of financial statements.**
Glossary of terms
Accounting. The process of identifying, measuring, recording and communicating economic information to others so that they may make decisions on the basis of that information.

Accounting policies. The specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

Accounting standards. Issued by the IASB or by national standard setting bodies, accounting standards form part of the regulatory framework. They set out the accounting treatment for numerous different areas and companies are expected to observe them if their financial statements are to be properly prepared.

Authoritative statements of how particular types of transactions and other events should be reflected in the financial statements.

Accounting system. The series of tasks and records of an entity by which the transactions are processed as a means of maintaining financial records.

Accruals concept. In the accruals basis of accounting, items are recognised as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the Conceptual Framework. Items of income and expenditure are matched and accounted for in the period in which they were earned / incurred rather than when the cash was received or paid.

Agency relationship. A contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent.

Asset. A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Auditors' report. Sets out the auditors' view of the financial statements and states whether they show a true and fair view / fair presentation of the financial performance and financial position of the entity.

Authoritative statements of how particular types of transactions and other events should be reflected in the financial statements.

Business entity concept. The concept that financial accounting information relates only to the activities of the business entity and not to the activities of its owner(s).

Capital expenditure. Expenditure on non-current assets, the net cost of which is to be 'capitalised' and depreciated over the anticipated useful working life of the assets.

Comparability. Accounting policies used should be disclosed, to make it possible for users to compare the company's results with its own prior years and with the results of other companies.

Conceptual framework. A statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

Conceptual Framework for Financial Reporting ('Conceptual Framework'). The IASB's conceptual framework upon which all IFRS are based. It determines how financial statements are prepared and the information they contain.

Corporate governance. The framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. It encompasses the mechanisms by which companies, and those in control, are held to account.

Current assets. Assets used in the trading activities of the business such as inventory, trade receivables and cash at bank.

Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Current Cost Accounting. Based upon the assumption that 'capital maintenance' should mean maintenance of the 'business substance' or 'operating capability' of the business entity.
**Current liabilities.** Amounts due in the shorter term such as trade payables and sales tax.

**Current purchasing power.** Measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

**Depreciation.** A method of spreading the cost of non-current assets over their useful lives with an annual charge to the statement of comprehensive income.

**Deprival value.** The lower of replacement cost and recoverable amount. In turn the recoverable amount is the higher of net realisable value and economic value.

**Directors' report.** A report contained in the annual report which gives a fair review of the development of the business during the year and of its position at the end of it.

**Economic value (EV), or value in use.** What the existing asset will be worth to the company over the rest of its useful life.

**Efficient market hypothesis.** The hypothesis that the stock market reacts immediately to all the information that is available. Therefore a long term investor cannot obtain higher than average returns from a well-diversified share portfolio.

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

**Expenses.** Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

**Fair value.** The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

**Faithful representation.** A faithful representation is complete, neutral and free from error.

**Financial accounting.** The accounting processes required for reporting the results and financial position of a business.

**Financial capital maintenance.** Profit is the increase in money capital over the period. It can be measured in either nominal monetary units or units of constant purchasing power.

**Financial reporting.** The process of classifying, recording and presenting financial data in accordance with generally established concepts and principles.

**Generally accepted accounting principles (GAAP).** Signifies all the rules, from whatever source, which govern accounting.

**Going concern concept.** The entity is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

**Historical cost.** Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.

**Income.** Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

**Internal control.** The system of controls that an entity establishes in order to provide reasonable assurance of the safeguarding of assets against unauthorised use or disposal and the maintenance of proper accounting records and the reliability of financial information used within the business or for publication.

**International Accounting Standards Board (IASB).** An independent, privately-funded accounting standard-setter. It is responsible for the setting of International Financial Reporting Standards (IFRS).

**IFRS Advisory Council.** Provides a formal vehicle to give advice to the IASB (Previously known as the Standards Advisory Council).

**IFRS Foundation.** An independent body that oversees the IASB.

**International Financial Reporting Standards Interpretations Committee (IFRSIC).** Provides timely guidance on the application and interpretation of International Financial Reporting Standards.
**Glossary of terms**

**International Financial Reporting Standards (IFRS).** The accounting standards issued by the IASB. Earlier accounting standards were known as International Accounting Standards (IAS) and many of these are still in issue.

**Liability.** A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

**Liquidity.** The availability of sufficient funds to meet deposit withdrawals and other short-term financial commitments as they fall due.

**Management accounting.** Sometimes known as cost accounting, it is a management information system which analyses data to provide information as a basis for managerial action.

**Management commentary.** A narrative report that provides users with explanations of the amounts presented in the financial statements. It also provides commentary on an entity’s prospects and other information not presented in the financial statements.

**Materiality.** Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

**Measurement.** The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of comprehensive income.

**Net realisable value** is the expected price less any costs still to be incurred in getting the item ready for sale and then selling it.

**Non-current assets.** Assets for long-term use within the business.

**Non-current liabilities.** Long-term liabilities usually due after more than one year.

**Normative accounting theory.** Explains what should occur rather than what actually does occur.

**Operating or Physical capital maintenance.** Profit is the increase in the physical productive capacity over the period.

**Positive accounting theory.** One where accounting theory is thought of as a body of knowledge that explains actual accounting practice.

**Profit.** The excess of revenue (income) over expenditure. When expenditure exceeds revenue, the business is running at a loss.

**Provision.** A present obligation which satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated.

**Realisable value.** The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.

**Recognition.** The process of incorporating in the statement of financial position or statement of comprehensive income an item that meets the definition of an element.

**Relevance.** Relevant financial information is capable of making a difference in the decisions made by users.

**Reliable financial information.** This has the following attributes:
- It reflects the substance of transactions i.e. represents faithfully what has taken place.
- It is free from bias, or neutral.
- It is free from material error.
- It is complete.
- Prudence has been applied where there is any uncertainty.

**Replacement cost.** The amount needed to replace an item with an identical item. This is the same as current cost.

**Reporting entity.** An entity for which there are users who rely on the financial statements as their major source of financial information about the entity.

**Revenue expenditure.** Expenditure incurred for the purpose of the trade of the business or to maintain the existing earning capacity of non-current assets.
Sales tax. A tax paid over to governments on each transaction but borne by the eventual consumer – also known as GST in some countries, including Australia.

Solvency. The availability of cash over the longer term to meet financial commitments as they fall due.

Statement of comprehensive income. Income of the business less expenses giving a final figure for profit. Sometimes referred to as an income statement or profit and loss account.

Statement of financial position. Key financial statement which lists the assets, liabilities and owners’ equity of a business. Sometimes referred to as a balance sheet.

Substance over form. The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Timeliness. Financial information should be available in time to be capable of influencing users’ decisions.

Trade payables. The amounts due to credit suppliers.

Trade receivables. The amounts owed by credit customers.

Understandability. Financial information needs to be capable of being understood by users 'having a reasonable knowledge of business and economic activities and accounting'.

Verifiability. Information is verifiable if different observers can broadly agree that a particular way of presenting an item is a faithful representation.
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