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This edition contains interpretations and application of the IFRS Standards, as approved by the International Accounting Standards Board (Board) for issue up to 31 December 2022, that are required to be applied for accounting periods beginning on 1 January 2023.

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1 INTRODUCTION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

INTRODUCTION

The mission of the IFRS Foundation and the International Accounting Standards Board (IASB) is to develop International Financial Reporting Standards (IFRS) that bring transparency, accountability and efficiency to financial markets around the world. They seek to serve the public interest by fostering trust, growth and long-term stability in the global economy. The IFRS Foundation also created the International Sustainability Standards Board to develop sustainability standards. These standards are outside the scope of this book.

The driver for the convergence of historically dissimilar financial reporting standards has been mainly to facilitate the free flow of capital so that, for example, investors in the US would become more willing to finance business in, say, China or the Czech Republic. Access to financial statements which are written in the same "language" would help to eliminate a major impediment to investor confidence, sometimes referred to as "accounting risk," which adds to the more tangible risks of making such cross-border investments. Additionally, permission to list a company's equity or debt securities on an exchange has generally been conditional on making filings with national regulatory authorities. These regulators tend to insist either on conformity with local Generally Accepted Accounting Principles (GAAP) or on a formal reconciliation to local GAAP. These procedures are tedious and time-consuming, and the human resources and technical knowledge to carry them out are not always widely available, leading many would-be registrants to forgo the opportunity of broadening their investor bases and potentially lowering their costs of capital.

There were once scores of unique sets of financial reporting standards among the more developed nations ("national GAAP"). The year 2005 saw the beginning of a new era in the global conduct of business, and the fulfilment of a 30-year effort to create the financial reporting rules for a worldwide capital market. During that year's financial reporting cycle, the 27 European Union (EU) member states plus many other countries, including Australia, New Zealand and South Africa, adopted IFRS.

This easing of US registration requirements for foreign companies seeking to enjoy the benefits of listing their equity or debt securities in the US led understandably to a call by domestic companies to permit them also to choose freely between financial reporting under US GAAP and IFRS. By late 2008 the SEC appeared to have begun the process of acceptance, first for the largest companies in those industries having (worldwide) the preponderance of IFRS adopters, and later for all publicly held companies. However, a new SEC chair took office in 2009, expressing a concern that the move to IFRS, if it were to occur, should perhaps take place more slowly than had previously been indicated.

It had been highly probable that non-publicly held US entities would have remained restricted to US GAAP for the foreseeable future. However, the American Institute of Certified Public Accountants (AICPA), which oversees the private-sector auditing profession's standards in the US, amended its rules in 2008 to fully recognise IASB as an accounting standard-setting body (giving it equal status with the Financial Accounting Standards Board (FASB)), meaning that auditors and other service providers in the US could now issue opinions (or provide other levels of assurance, as specified under pertinent guidelines). This change, coupled with the promulgation by IASB of a long-sought standard providing simplified financial reporting rules for privately held entities (described later in this chapter), might be seen as increasing the likelihood that a more broadly based move to IFRS will occur in the US over the coming years.

The historic 2002 Norwalk Agreement—embodied in a Memorandum of Understanding (MoU) between the US standard setter, FASB, and the IASB—called for "convergence" of the respective sets of standards, and indeed since that time, a number of revisions of either US GAAP or IFRS have already taken place to implement this commitment.

Despite this commitment by the IASB and the FASB (collectively, the 'Boards') , certain projects such as financial instruments (impairment and hedge accounting), revenue recognition, leases and insurance contracts were deferred due to their complexity and the difficulty in reaching consensus views. The converged standard on revenue recognition, IFRS 15, was finally published in May 2014, although both Boards subsequently deferred its effective date to annual periods beginning on or after January 1, 2018. The standard on leasing, IFRS 16, was published in January 2016, bringing to completion the work of the Boards on the MoU projects. Details of these and other projects of the standard setters are included in a separate section in each relevant chapter of this book.

Despite the progress towards convergence described above, the SEC dealt a blow to hopes of future alignment in its strategic plan published in February 2014. The document states that the SEC "will consider, among other things, whether a single set of high-quality global accounting standards is achievable," which is a significant reduction in its previously expressed commitment to a single set of global standards. This leaves IFRS and US GAAP as the two comprehensive financial reporting frameworks in the world, with IFRS gaining more and more momentum.

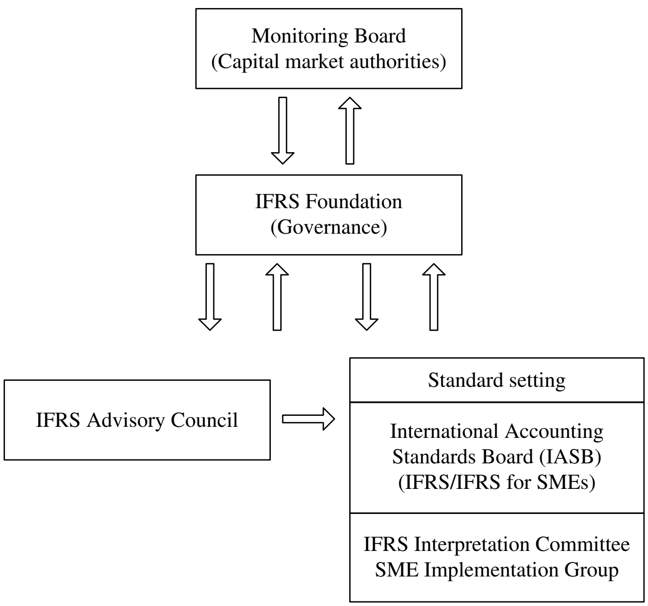
The completed MoU with FASB (and with other international organisations and jurisdictional authorities) has been replaced by a MoU with the Accounting Standards Advisory Forum (ASAF). The ASAF is an advisory group to the IASB, which was set up in 2013. It consists of national standard setters and regional bodies with an interest in financial reporting. Its objective is to provide an advisory forum where members can constructively contribute towards the achievement of the IASB's goal of developing globally accepted high-quality accounting standards. FASB's involvement with the IASB is now through ASAF.

The International Sustainability Standards Board (ISSB) is an independent body that develops and approves IFRS Sustainability Disclosure Standards and was formed in 2021, following various stakeholder consultations on demand for global sustainability standards. The ISSB operates under the oversight of the IFRS Foundation.

The ISSB has complete responsibility for all sustainability-related technical matters of the IFRS Foundation including full discretion in developing and pursuing its technical agenda and the preparation and issuing of exposure drafts, following the due process stipulated in the Constitution.

THE CURRENT STRUCTURE

The formal structure put in place in 2000 has the IFRS Foundation, a Delaware corporation, as its keystone (this was previously known as the IASC Foundation). The Trustees of the IFRS Foundation have both the responsibility to raise funds needed to finance standard setting, and the responsibility of appointing members to the IASB, the IFRS Interpretations Committee (IFRIC) and the IFRS Advisory Council. The structure was amended to incorporate the IFRS Foundation Monitoring Board ("Monitoring Board") in 2009, renaming and incorporating the SME Implementation Group in 2010 as follows:



The Monitoring Board is responsible for ensuring that the Trustees of the IFRS Foundation discharge their duties as defined by the IFRS Foundation Constitution and for approving the appointment or reappointment of Trustees. The Monitoring Board consists of the Boards (as defined above) and the Growth and Emerging Markets Committees of the IOSCO (The International Organization of Securities Commissions—an international body that brings together the world's securities regulators and is recognised as the global standard setter for the securities sector), the Financial Services Agency of Japan (JFSA), the SEC, the Brazilian Securities Commission (CVM), the Financial Services Commission of Korea (FSC) and Ministry of Finance of the People's Republic of China (China MOF). The Basel Committee on Banking Supervision participates as an observer.

The IFRS Foundation is governed by trustees and reports to the Monitoring Board. The IFRS Foundation has fundraising responsibilities and oversees the standard-setting work, the IFRS structure and strategy. It is also responsible for a five-yearly, formal, public review of the Constitution.

The IFRS Advisory Council is the formal advisory body to the IASB and the Trustees of the IFRS Foundation. Members consist of user groups, preparers, financial analysts, academics, auditors, regulators, professional accounting bodies and investor groups.

The IASB is an independent body that is solely responsible for establishing IFRS, including the IFRS for small and medium-sized enterprises (SMEs). The IASB also approves new interpretations.

The IFRS Interpretations Committee (the Interpretations Committee) is a committee comprised partly of technical partners in audit firms but also includes preparers and users. The Interpretations Committee's function is to answer technical queries from constituents about how to interpret IFRS—in effect, filling in the cracks between different requirements. It also proposes modifications to standards to the IASB, in response to perceived operational difficulties or the need to improve consistency. The Interpretations Committee liaises with the US Emerging Issues Task Force and similar bodies and standard setters to preserve convergence at the level of interpretation.

Working relationships are set up with local standard setters who have adopted or converged with IFRS, or are in the process of adopting or converging with IFRS.

PROCESS OF IFRS STANDARD-SETTING

The IASB has a formal due process, which is currently set out in the *IFRS Foundation Due Process Handbook* issued in February 2013 by the Due Process Oversight Committee (DPOC), and updated in June 2016 to include the final IFRS Taxonomy due process.

The DPOC is responsible for:

1. reviewing regularly, and in a timely manner, together with the IASB and the IFRS Foundation staff, the due process activities of the standard-setting activities of the IASB;
2. reviewing, and proposing updates to, the *Due Process Handbook* that relates to the development and review of Standards, Interpretations and the IFRS Taxonomy so as to ensure that the IASB procedures are best practice;
3. reviewing the composition of the IASB's consultative groups to ensure an appropriate balance of perspectives and monitoring the effectiveness of those groups;

4. responding to correspondence from third parties about due process matters, in collaboration with the Director for Trustee Activities and the technical staff;
5. monitoring the effectiveness of the IFRS Advisory Council ("Advisory Council"), the Interpretations Committee and other bodies of the IFRS Foundation relevant to its standard-setting activities; and
6. making recommendations to the Trustees about constitutional changes related to the composition of committees that are integral to due process, as appropriate.

As a minimum, a proposed standard should be exposed for comment, and these comments should be reviewed before issuance of a final standard, with debates open to the public. However, this formal process is rounded out in practice, with wider consultation taking place on an informal basis.

The IASB's agenda is determined in various ways. Suggestions are made by the Trustees, the IFRS Advisory Council, liaison standard setters, the international accounting firms and others. These are debated by IASB and tentative conclusions are discussed with the various consultative bodies. Long-range projects are first put on the research agenda, which means that preliminary work is being done on collecting information about the problem and potential solutions. Projects can also arrive on the current agenda outside that route.

Once a project reaches the current agenda, the formal process is that the staff (a group of about 20 technical staff permanently employed by the IASB) drafts papers which are then discussed by IASB in open meetings. Following that debate, the staff rewrites the paper, or writes a new paper, which is then debated at a subsequent meeting. In theory at least, there is an internal process where the staff proposes solutions, and IASB either accepts or rejects them. In practice, the process is more involved: sometimes (especially for projects such as financial instruments) individual Board members are delegated special responsibility for the project, and they discuss the problems regularly with the relevant staff, helping to build the papers that come to the Board. Equally, Board members may write or speak directly to the staff outside of the formal meeting process to indicate concerns about one matter or another.

The due process comprises six stages: (1) setting the agenda; (2) project planning; (3) developing and publishing a Discussion Paper; (4) developing and publishing an Exposure Draft; (5) developing and publishing the IFRS; and (6) procedures after an IFRS is issued. The process also includes discussion of Staff Papers outlining the principal issues and analysis of comments received on Discussion Papers and Exposure Drafts. A pre-ballot draft is normally subject to external review. A near-final draft is also posted on the limited access website. If all outstanding matters are resolved, the final ballot is applied.

Final ballots on the standard are carried out in secret, but otherwise the process is quite open, with outsiders able to consult project summaries on the IASB website and attend Board meetings if they wish. Of course, the informal exchanges between staff and Board on a day-to-day basis are not visible to the public, nor are the meetings where IASB takes strategic and administrative decisions.

The basic due process can be modified in different circumstances. The Board may decide not to issue Discussion Papers or to reissue Discussion Papers and Exposure Drafts.

The IASB also has regular public meetings with the Capital Markets Advisory Committee (CMAC) and the Global Preparers Forum (GPF), among others. Special groups are set up from time to time. An example was the Financial Crisis Advisory Group, which was set up to consider how improvements in financial reporting could help enhance investor confidence in financial markets in the wake of the financial crisis of 2008. Formal working groups are established for certain major projects to provide additional practical input and expertise. Apart from these formal consultative processes, IASB also carries out field trials of some standards (examples of this include performance reporting and insurance), where volunteer preparers apply the proposed new standards. The IASB may also hold some form of public consultation during the process, such as roundtable discussions. The IASB engages closely with stakeholders around the world such as investors, analysts, regulators, business leaders, accounting standard setters and the accountancy profession.

The revised *IFRS Foundation Due Process Handbook* has an introduction section dealing with oversight, which identifies the responsibilities of the DPOC. The work of the IASB is divided into development and maintenance projects. Developments are comprehensive projects such as major changes and new IFRS Standards. Maintenance consists of narrow scope amendments. A research programme is also described that should form the development base for comprehensive projects. Each phase of a major project should also include an effects analysis detailing the likely cost and benefits of the project.

Appendix A: Current International Financial Reporting Standards (IAS/IFRS) And Interpretations (SIC/IFRIC)

IFRS 1	First-Time Adoption of IFRS
IFRS 2	Share-Based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments (effective for accounting periods commencing on or after January 1, 2018 and will supersede IAS 39 and IFRIC 9)
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interest in Other Entities
IFRS 13	Fair Value Measurement
IFRS 14	Regulatory Deferral Accounts
IFRS 15	Revenue from Contracts with Customers
IFRS 16	Leases
IFRS 17	Insurance Contracts
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 11	Construction Contracts (replaced by IFRS 15)
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue (replaced by IFRS 15)

IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related-Party Disclosure
IAS 26	Accounting and Reporting by Retirement Benefit Plans
IAS 27	Separate Financial Statements
IAS 28	Investments in Associates and Joint Ventures
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement (replaced by IFRS 9)
IAS 40	Investment Property
IAS 41	Agriculture
IFRIC 1	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 2	Members' Shares in Co-operative Entities and Similar Instruments
IFRIC 4	Determining Whether an Arrangement Contains a Lease
IFRIC 5	Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
IFRIC 6	Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment
IFRIC 7	Applying the Restatement Approach under IAS 29, *Financial Reporting in Hyperinflationary Economies*
IFRIC 9	Reassessment of Embedded Derivatives (replaced by IFRS 9)
IFRIC 10	Interim Financial Reporting and Impairment
IFRIC 12	Service Concession Arrangements
IFRIC 13	Customer Loyalty Programmes (replaced by IFRS 15)
IFRIC 14	IAS 19—*The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*
IFRIC 15	Agreements for the Construction of Real Estate (replaced by IFRS 15)
IFRIC 16	Hedges of a Net Investment in a Foreign Operation
IFRIC 17	Distributions of Non-cash Assets to Owners
IFRIC 18	Transfer of Assets from Customers (replaced by IFRS 15)
IFRIC 19	Extinguishing Financial Liabilities with Equity Instruments
IFRIC 20	Stripping Costs in the Production Phase of a Surface Mine
IFRIC 21	Levies
IFRIC 22	Foreign Currency Transactions and Advance Consideration
IFRIC 23	Uncertainty over Income Tax Treatments
SIC 7	Introduction of the Euro
SIC 10	Government Assistance—No Specific Relation to Operating Activities
SIC 25	Income Taxes—Changes in the Tax Status of an Enterprise or its Shareholders
SIC 29	Disclosure—Service Concession Arrangements
SIC 32	Intangible Assets—Website Costs

APPENDIX B: IFRS FOR SMEs

A long-standing debate among professional accountants, users and preparers—between those advocating some form of simplified financial reporting standards for smaller or non-publicly responsible entities (however they are defined), and those arguing that all reporting entities purporting to adhere to officially mandated accounting standards should do so with absolute faithfulness—was resolved on July 9, 2009 with the publication of the *International Financial Reporting Standard (IFRS) for Small and Medium-Sized Entities (IFRS for SMEs)*. Notwithstanding the name, it is actually intended as an optional, somewhat simplified and choice-limited comprehensive financial reporting standard for enterprises not having public accountability. Many of the recognition and measurement principles in full IFRS have been simplified, disclosures significantly reduced and topics not relevant to SMEs omitted from the IFRS for SMEs. The IASB carried out a comprehensive review of the *IFRS for SMEs* which it completed in May 2015 resulting in limited amendments to the standard. A complete revised version of the standard was issued in December 2015 and is effective from January 1, 2017. The IASB expects that revisions to the standard will be limited to once every three years.

The *IFRS for SMEs* is not immediately updated for any changes to full IFRS but, as noted above, the IASB issued amendments in the first half of 2015 and then anticipates updating the standard every three years thereafter.

The IASB has published a Request for information for commentary at 27 October 2020 to seeks views on how to align the IFRS for SMEs with full IFRS. The next step is to considers when the second comprehensive review should be done.

Definition of SMEs

The *IFRS for SMEs* is intended for entities that do not have public accountability. An entity has public accountability—and therefore would not be permitted to use the *IFRS for SMEs*—if it meets either of the following conditions: (1) it has issued debt or equity securities in a public market; or (2) it holds assets in a fiduciary capacity, as one of its primary businesses, for a broad group of outsiders. The latter category of entity would include most banks, insurance companies, securities brokers/dealers, pension funds, mutual funds and investment banks. The standard does not impose a size test in defining SMEs, notwithstanding its name.

The standard also states that it is intended for entities which publish financial statements for external users, as with IFRS and US GAAP. In other words, the standard is not intended to govern internal or managerial reporting, although there is nothing to prevent such reporting from fully conforming to such standards.

A subsidiary of an entity that employs full IFRS, or an entity that is part of a consolidated entity that reports in compliance with IFRS, may report, on a stand-alone basis, in accordance with the *IFRS for SMEs*, if the financial statements are so identified, and if the subsidiary does not have public accountability itself. If this is done, the standard must be fully complied with, which could mean that the subsidiary's stand-alone financial statements would differ from how they are presented within the parent's consolidated financial statements; for example, in the subsidiary's financial statements prepared in accordance with the *IFRS for SMEs*, borrowing costs incurred in connection with the construction of long-lived assets would be expensed as incurred, but those same borrowing costs would be capitalised in the consolidated financial statements, since IAS 23 as most recently revised no longer provides the option of immediate expensing. In the authors' view, this would not be optimal financial reporting, and the goals of consistency and comparability would be better served if the stand-alone financial statements of the subsidiary were also based on full IFRS.

IFRS for SMEs is a Complete, Self-Contained Set of Requirements

The *IFRS for SMEs* is a complete and comprehensive standard, and accordingly contains much or most of the vital guidance provided by full IFRS. For example, it defines the qualities that are needed for IFRS-compliant financial reporting (reliability, understandability, et al.), the elements of financial statements (assets, liabilities, et al.), the required minimum captions in the required full set of financial statements, the mandate for comparative reporting and so on. There is no need for an entity reporting under this standard to refer elsewhere (other than for guidance in IAS 39, discussed below), and indeed it would be improper to do so.

An entity having no public accountability, which elects to report in conformity with the *IFRS for SMEs*, must make an "explicit and unreserved" declaration to that effect in the notes to the financial statements. As with a representation that the financial statements comply with full IFRS, if this representation is made, the entity must comply fully with all relevant requirements in the standard(s).

Many options under full IFRS remain under the *IFRS for SMEs*. For example, a single statement of comprehensive income may be presented, with profit or loss being an intermediate step in the derivation of the period's comprehensive income or loss, or alternatively a separate statement of income can be displayed, with profit or loss (the "bottom line" in that statement) then being the opening item in the separate statement of comprehensive income. Likewise, most of the mandates under full IFRS, such as the requirement to consolidate special-purpose entities that are controlled by the reporting entity, also exist under the *IFRS for SMEs*.

Modifications of Full IFRS Made in the IFRS for SMEs

Compared to full IFRS, the aggregate length of the standard, in terms of number of words, has been reduced by more than 90%. This was achieved by removing topics deemed not to be generally relevant to SMEs, by eliminating certain choices of accounting treatments and by simplifying methods for recognition and measurement. These three sets of modifications to the content of full IFRS, which are discussed below, respond both to the perceived needs of users of SMEs' financial statements and to cost-benefit concerns. According to the IASB, the set of standards in the *IFRS for SMEs* will be suitable for a typical enterprise having 50 employees and will also be valid for so-called micro-entities having only a single or a few employees. However, no size limits are stipulated in the standard, and thus even very large entities could conceivably elect to apply the *IFRS for SMEs*, assuming they have no public accountability as defined in the standard, and that no objections are raised by their various other stakeholders, such as lenders, customers, vendors or joint venture partners.

Omitted topics. Certain topics covered in the full IFRS were viewed as not being relevant to typical SMEs (e.g., rules pertaining to transactions that were thought to be unlikely to occur in an SME context), and have accordingly been omitted from the standard. This leaves open the question of whether SMEs could optionally seek expanded guidance in the full IFRS. Originally, when the Exposure Draft of the *IFRS for SMEs* was released, cross-references to the full IFRS were retained, so that SMEs would not be precluded from applying any of the financial reporting standards and methods found in IFRS, essentially making the *IFRS for SMEs* standard entirely optional on a component-by-component basis. However, in the final *IFRS for SMEs* standard all of these cross-references have been removed, with the exception of a reference to IAS 39, *Financial Instruments: Recognition and Measurement*, thus making the *IFRS for SMEs* a fully stand-alone document, not to be used in conjunction with the full IFRS. An entity that would qualify for use of the *IFRS for SMEs* must therefore make a decision to use full IFRS or the *IFRS for SMEs* exclusively.

Topics addressed in full IFRS, which are entirely omitted from the *IFRS for SME*s, are as follows:

- Earnings per share;
- Interim reporting;
- Segment reporting;
- Special accounting for assets held for sale;
- Insurance (since, because of public accountability, such entities would be precluded from using *IFRS for SMEs* in any event).

Thus, for example, if a reporting entity concluded that its stakeholders wanted presentation of segment reporting information, and the entity's management wished to provide that to them, it would elect to prepare financial statements in conformity with the full set of IFRS, rather than under the *IFRS for SMEs*.

Only the simpler option included. Where full IFRS provides an accounting policy choice, generally only the simpler option is included in *IFRS for SMEs*. SMEs will not be permitted to employ the other option(s) provided by the full IFRS, as had been envisioned by the Exposure Draft that preceded the standard, as all cross-references to the full IFRS have been eliminated.

The simpler options selected for inclusion in *IFRS for SMEs* are as follows, with the excluded alternatives noted:

- For investment property, measurement is driven by circumstances rather than a choice between the cost and fair value models, both of which are permitted under IAS 40, *Investment Property*. Under the provisions of the *IFRS for SMEs*, if the fair value of investment property can be measured reliably without undue cost or effort, the fair value model must be used. Otherwise, the cost method is required.
- Use of the cost-amortisation-impairment model for intangible assets is required; the revaluation model set out in IAS 38, *Intangible Assets*, is not allowed.
- Immediate expensing of borrowing costs is required; the capitalisation model stipulated under revised IAS 23 is not deemed appropriate for SMEs.
- Jointly controlled entities cannot be accounted for under the proportionate consolidation method under the *IFRS for SMEs* but can be under full IFRS as they presently exist. The *IFRS for SMEs* does permit the use of the fair value-through-earnings method as well as the equity method, and even the cost method can be used when it is not possible to obtain price or value data.
- Entities electing to employ the *IFRS for SMEs* are required to expense development costs as they are incurred, together with all research costs. Full IFRS necessitates making a distinction between research and development costs, with the former expensed and the latter capitalised and then amortised over an appropriate period receiving economic benefits.

It should be noted that the Exposure Draft that preceded the original version of the *IFRS for SMEs* would have required that the direct method for the presentation of operating cash flows be used, to the exclusion of the less desirable, but vastly more popular, indirect method. The final standard has retreated from this position and permits both methods, so it includes necessary guidance on application of the indirect method, which was absent from the draft.

All references to full IFRS found in the original draft of the standard have been eliminated, except for the reference to IAS 39, which may be used, optionally, by entities reporting under the *IFRS for SMEs*. The general expectation is that few reporting entities will opt to do this, since the enormous complexity of that standard was a primary impetus to the development of the streamlined *IFRS for SMEs*.

It is inevitable that some financial accounting or reporting situations will arise for which the *IFRS for SMEs* itself will not provide complete guidance. The standard provides a hierarchy, of sorts, of additional literature upon which reliance could be placed, in the absence of definitive rules contained in the *IFRS for SMEs*. First, the requirements and guidance that are set out for highly similar or closely related circumstances would be consulted within the *IFRS for SMEs*. Secondly, the *Concepts and Pervasive Principles* section (Section 1.2) of the standard would be consulted, in the hope that definitions, recognition criteria and measurement concepts (e.g., for assets, revenues) would provide the preparer with sufficient guidance to reason out a valid solution. Thirdly, and lastly, full IFRS is identified explicitly as a source of instruction. Although reference to US (or other) GAAP is not suggested as an alternate, (since full IFRS permits preparers to consider the requirements of another GAAP, if based on a framework similar to full IFRS, where an item is not covered under IFRS such as the concept of merger accounting) this does not permit departure from IFRS.

Recognition and measurement simplifications. For the purposes of the *IFRS for SMEs*, IASB has made significant simplifications to the recognition and measurement principles included in full IFRS. Examples of the simplifications to the recognition and measurement principles found in full IFRS are as follows:

1. *Financial instruments*:

   a. *Classification of financial instruments*. Only two categories for financial assets (cost or amortised cost, and fair value through profit or loss) are provided. The fair value through other comprehensive income is not available.

      (1) The *IFRS for SMEs* requires an amortised cost model for most debt instruments, using the effective interest rate as at initial recognition. The effective rate should consider all contractual terms, such as prepayment options. Investments in non-convertible and non-puttable preference shares and non-puttable ordinary shares that are publicly traded or whose fair value can otherwise be measured reliably are to be measured at fair value with changes in value reported in current earnings. Most other basic financial instruments are to be reported at cost less any impairment recognised. Impairment or uncollectability must always be assessed, and, if identified, recognised immediately in profit or loss; recoveries to the extent of losses previously taken are also recognised in profit or loss.

      (2) For more complex financial instruments (such as derivatives), fair value through profit or loss is generally the applicable measurement method, with cost less impairment being prescribed for those instruments (such as equity instruments lacking an objectively determinable fair value) for which fair value cannot be ascertained.

(3) Assets which would generally not meet the criteria as being basic financial instruments include: (a) asset-backed securities, such as collateralised mortgage obligations, repurchase agreements and securitised packages of receivables; (b) options, rights, warrants, futures contracts, forward contracts and interest rate swaps that can be settled in cash or by exchanging another financial instrument; (c) financial instruments that qualify and are designated as hedging instruments in accordance with the requirements in the standard; (d) commitments to make a loan to another entity; and, (e) commitments to receive a loan if the commitment can be net settled in cash. Such instruments would include: (a) an investment in another entity's equity instruments other than non-convertible preference shares and non-puttable ordinary and preference shares; (b) an interest rate swap, which returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument, which is capable of being cash settled and which, on settlement, could have positive or negative cash flow; (c) options and forward contracts, because returns to the holder are not fixed; (d) investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates; and, (e) a loan receivable from a third party that gives the third party the right or obligation to prepay if the applicable taxation or accounting requirements change.

b. *Derecognition*. In general, the principle to be applied is that, if the transferor retains any significant risks or rewards of ownership, derecognition is not permitted, although if full control over the asset is transferred, derecognition is valid even if some very limited risks or rewards are retained. The complex "passthrough testing" and "control retention testing" of IAS 39 can thus be omitted, unless full IAS 39 is elected for by the reporting entity. For financial liabilities, derecognition is permitted only when the obligation is discharged, canceled or expires.
c. *Simplified hedge accounting*. Much more simplified hedge accounting and less strict requirements for periodic recognition and measurement of hedge effectiveness are specified than those set out in IAS 39.
d. *Embedded derivatives*. No separate accounting for embedded derivatives is required.

2. *Goodwill impairment*: An indicator approach has been adopted to supersede the mandatory annual impairment calculations in IFRS 3, *Business Combinations*. Additionally, goodwill and other indefinite-lived assets are considered to have finite lives, thus reducing the difficulty of assessing impairment.
3. *All research and development costs are expensed as incurred* (IAS 38 requires capitalisation after commercial viability has been assessed).
4. *The cost method or fair value through profit or loss of accounting for associates and joint ventures may be used* (rather than the equity method or proportionate consolidation).
5. *Simplified accounting for deferred taxes*: The "temporary difference approach" for recognition of deferred taxes under IAS 12, *Income Taxes*, is allowed with a minor

modification. Current and deferred taxes are required to be measured initially at the rate applicable to undistributed profits, with adjustment in subsequent periods if the profits are distributed.

6. *Less use of fair value for agriculture* (being required only if fair value is readily determinable without undue cost or effort).
7. *Share-based payment*: Equity-settled share-based payments should always be recognised as an expense and the expense should be measured on the basis of observable market prices, if available. When there is a choice of settlement, the entity should account for the transaction as a cash-settled transaction, except under certain circumstances.
8. *Finance leases*: A simplified measurement of a lessee's rights and obligations is prescribed.
9. *First-time adoption*: Less prior period data would have to be restated than under IFRS 1, *First-time Adoption of International Financial Reporting Standards*. An impracticability exemption has also been included.

Because the default measurement of financial instruments would be fair value through profit and loss under the *IFRS for SMEs*, some SMEs may actually be required to apply more fair value measurements than do entities reporting under full IFRS.

Disclosure Requirements Under the IFRS for SMEs

There are certain reductions in disclosure requirements under the *IFRS for SMEs* compared to full IFRS, but these are relatively minor and alone would not drive a decision to adopt the standard. Furthermore, key stakeholders, such as banks, often prescribe supplemental disclosures (e.g., major contracts, compensation agreements), which exceed what is required under IFRS, and this would be likely to continue to be true under the *IFRS for SMEs*.

Maintenance of the IFRS for SMEs

SMEs have expressed concerns not only over the complexity of IFRS, but also about the frequency of changes to standards. To respond to these issues, IASB intends to update the *IFRS for SMEs* approximately once every three years via an "omnibus" standard, with the expectation that any new requirements would not have mandatory application dates sooner than one year from issuance. Users are thus assured of having a moderately stable platform of requirements.

Implications of the IFRS for SMEs

The *IFRS for SMEs* is a significant development, which appears to be having a real impact on the future accounting and auditing standards issued by organisations participating in the standard-setting process.

On March 6, 2007, the FASB and the AICPA announced that the newly established Private Company Financial Reporting Committee (PCFRC) will address the financial reporting needs of private companies and of the users of their financial statements. In addition, on May 23, 2012, the Financial Accounting Foundation announced its decision to make process and structural improvements in private company financial reporting by creating the Private Company Council (PCC). The primary objective of PCFRC and PCC is to help the

FASB determine whether and where there should be specific differences in prospective and existing accounting standards for private companies.

In many continental European countries, a close link exists between the statutory financial statements and the results reported for income tax purposes. The successful implementation of SME Standards will require breaking the traditional bond between the financial statements and the income tax return, and may well trigger a need to amend company laws.

Since it is imperative that international convergence of accounting standards be accompanied by convergence of audit standards, differential accounting for SMEs will affect regulators such as the Public Company Accounting Oversight Board (PCAOB) and the SEC. The *IFRS for SMEs* may be a welcome relief for auditors as it will decrease the inherent risk that results from the numerous choices and wide-ranging judgement required by management when utilising the full version of IFRS. The ultimate success of the *IFRS for SMEs* will depend on the extent to which users, preparers and their auditors believe the standard meets their needs.

Application of the IFRS for SMEs

The application of the *IFRS for SMEs* is not covered in this publication. However, there is a detailed accounting manual available, which addresses the requirements, application and interpretation of the standard—*Applying IFRS for SMEs* (available from Wiley).

2 CONCEPTUAL FRAMEWORK

INTRODUCTION

In March 2018 the IASB completed the project with the issue of its revised *Conceptual Framework for Financial Reporting* (the 2018 framework).

The IASB and IFRS Interpretations Committee are using the 2018 framework in developing and revising standards and interpretations.

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING 2018

Structure

The 2018 framework consists of an introduction setting the status and purpose of the framework, and eight chapters as follows:

1. **The Objective of General-Purpose Financial Reporting:** this chapter is largely unchanged from the 2010 framework, although the IASB has clarified why information used in assessing stewardship is needed to achieve the objective of financial reporting;
2. **Qualitative Characteristics of Useful Financial Information:** this chapter is largely unchanged from the 2010 framework, although the IASB has clarified the roles of prudence, measurement uncertainty and substance over form in assessing whether information is useful;
3. **Financial Statements and the Reporting Entity:** this is a new chapter, which provides guidance on determining the appropriate boundary of a reporting entity;

4. **The Elements of Financial Statements:** the definitions of assets and liabilities have been refined and, following on from this, the definitions of income and expenses have been updated;
5. **Recognition and Derecognition:** the previous recognition criteria have been revised to refer explicitly to the qualitative characteristics of useful information. New guidance on derecognition has been provided;
6. **Measurement:** this chapter has been expanded significantly to describe the information which measurement bases provide and explanations of the factors to be considered when selecting a measurement basis;
7. **Presentation and Disclosure:** this is a new chapter, which sets out concepts that describe how information should be presented and disclosed in financial statements; and
8. **Concepts of Capital and Capital Maintenance:** the material in this chapter has been carried forward unchanged from the 2010 framework, into which it was transferred unchanged from the IASC's 1989 framework.

Status and Purpose

The 2018 framework describes the objective of, and the concepts for, general-purpose financial reporting.

The purpose of the 2018 framework is to:

a. assist the IASB to develop standards which are based on consistent concepts;
b. assist preparers to develop consistent accounting policies when no standard applies to a particular transaction or other event; and
c. assist all parties to understand and interpret the standards.

The 2018 framework is not a standard, and nothing in the framework overrides any standard or any requirement which the standards contain.

The main aim is therefore to help the IASB in preparing new standards and reviewing existing standards. The conceptual framework also helps national standard setters, preparers, auditors, users and others interested in IFRS in achieving their objectives. The conceptual framework is, however, not itself regarded as an IFRS and therefore cannot override any IFRS although there might be potential conflicts. The IASB believes that over time any such conflicts will be eliminated.

1. The Objective of General-Purpose Financial Reporting

The objective of general-purpose financial reporting is defined in the 2018 framework as follows:

> To provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.

The decisions to be made concern:

a. buying, selling or holding equity and debt instruments;
b. providing or settling loans and other forms of credit; or
c. exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

Since investors, lenders and other creditors are generally not in a position to have the necessary information issued directly to them they have to rely on general-purpose financial reports to make decisions. They are therefore identified as the primary users of general-purpose financial reports.

The framework recognises that users need to evaluate the prospects for future net cash inflows to an entity. To assess these net inflows, information is needed of an entity's resources, claims to those resources and the ability of management and the governing board to discharge their responsibility to use the resources. Assessing stewardship is thus included in the ability of users to assess the net cash flows of an entity.

It is noted that general-purpose financial reports do not provide information regarding the value of a reporting entity but assist in making such valuations.

General-purpose financial reports provide information about the financial position of an entity, its resources and claims against those resources. The entity's financial position is affected by the economic resources which the entity controls, its financial structure, its liquidity and solvency and its capacity to adapt to changes in the environment in which it operates. Information is provided about the strengths and weaknesses of an entity and its ability to acquire finance.

Changes in an entity's economic resources and claims are a result of an entity's financial performance and are derived from other transactions such as issuing debt and equity instruments.

Financial performance is assessed both through the process of accrual accounting and changes in cash flows. Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the period in which those effects occur, even if the resultant cash payments and receipts arise in a different period. Information about the cash flows which occur during a period assists users in assessing the entity's ability to generate future net cash flows. Accrual accounting and reporting of cash flows both help users to understand the return on the resources of an entity and how well management has discharged its stewardship responsibilities.

Changes in economic resources and claims may also occur for reasons other than financial performance. For example, debt or equity instruments may be issued, resulting in cash inflows. Information about these types of changes is necessary to provide users with a complete understanding of why economic resources and claims have changed, and the implications of those changes for future financial performance.

Information about how efficiently and effectively the reporting entity's management has discharged its responsibilities in relation to the entity's economic resources helps users to assess management's stewardship of those resources. This can assist users in assessing management's future stewardship of the entity's resources.

2. Qualitative Characteristics of Useful Financial Information

The qualitative characteristics identify the information which is most useful in financial reporting. Financial reporting includes information in financial statements and financial information that is provided by other means. The qualitative characteristics are divided into fundamental qualitative characteristics and enhancing qualitative characteristics.

The fundamental qualitative characteristics are relevance and faithful representation. Financial information is useful if it possesses these characteristics.

The enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability. The usefulness of financial information is enhanced if it possesses these characteristics.

No hierarchy of applying the qualitative characteristics is determined. The application is, however, a process. The fundamental characteristics are applied by following a three-step process. First, it is necessary to identify the economic phenomenon which has a potential to be useful. Secondly, the type of information regarding the phenomenon that is most relevant that could be faithfully represented should be identified. Finally, it should be determined whether the information is available and could be faithfully represented.

It may be necessary to make a trade-off between relevance and faithful representation to meet the objective of financial reporting, which is to provide useful information about economic phenomena. It is possible that the most relevant information about an economic phenomenon could be a highly uncertain estimate. Measurement uncertainty can sometimes be so high that it may be questionable whether the estimate would provide a sufficiently faithful representation of the economic phenomenon. In such a case, it would be necessary to determine whether the most useful information would be provided by that estimate accompanied by a detailed description of the estimate and an explanation of the uncertainties which accompany it, or whether it would be more useful to provide a less relevant estimate which nonetheless was subject to lower measurement uncertainty.

Once the process described above has been followed, the enhancing characteristics are applied to confirm or enhance the quality of the information.

The fundamental qualitative characteristics are explained as follows:

- *Relevant* financial information can make a difference in decision making. Information can make a difference if it has predictive value, confirmatory value or both. Financial information has predictive value if it can be used as an input in the process to predict future outcomes and has confirmatory value if it confirms or changes previous evaluations. Materiality is included in relevance. Information is material if omitting it or misstating it could influence the decisions of users.
- *Faithful representation* is achieved when information is complete, neutral and free from error. A complete depiction includes all information needed to understand the economic phenomena under consideration, including any necessary descriptions and explanations. A neutral depiction is one which is without bias in the selection or presentation of financial information. Neutrality is supported by the exercise of prudence, which means that assets and income are not overstated, and liabilities and expenses are not understated. (Equally, prudence does not allow for the understatement of assets or income, or the overstatement of liabilities or expenses.) "Free from error" means that there are no errors or omissions in the description of the phenomena and in the process applied (although this does not require that information be perfectly accurate in all respects). The framework acknowledges that in many instances it may be necessary to include estimates in financial information.

The enhancing qualitative characteristics are explained as follows:

- *Comparability* enables users to identify similarities in, and differences between, 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. *Consistency* (the use of the same methods for the same items, either from period to period within the same entity or in a single period across entities) aids comparability, although it is not the same as comparability.

- *Verifiability* helps to assure users that information represents faithfully the economic phenomena which it purports to represent. It implies that knowledgeable and independent observers could reach a consensus (but not necessarily absolute agreement) that the information does represent faithfully the economic phenomena it purports to represent without material error or bias, or that an appropriate recognition or measurement method has been applied without material error or bias. It means that independent observations would yield essentially the same measure or conclusions.
- *Timeliness* means that the information is provided to users in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it may be to the users.
- *Understandability* is classifying, characterising and presenting information clearly and concisely. Understandability enables users who have a reasonable knowledge of business, economic and financial activities and financial reporting, and who apply reasonable diligence to comprehend the information, to gain insights into the reporting entity's financial position and results of operations, as intended.

The cost constraint is the only constraint included regarding the information provided in useful financial reports. At issue is whether the benefits of providing information exceed the cost of providing and using the information. In developing standards, the IASB considers information about the expected benefits and costs of those benefits which will result. Presumably this would constrain the imposition of certain new requirements, although this is a relative concept, and as information technology continues to evolve and the cost of preparing and distributing financial and other information declines, this constraint conceivably may be relaxed.

3. Financial Statements and the Reporting Entity

This chapter discusses the role of general-purpose financial statements (which are a particular form of general-purpose financial report) and the concept of the reporting entity.

The chapter sets out that general-purpose financial statements consist of a statement of financial position (recognising assets, liabilities and equity), a statement of financial performance which may be a single statement or two statements (recognising income and expenses), and other statements and notes which present information about recognised elements (assets, liabilities, equity, income and expenses), unrecognised elements, cash flows, contributions from and distributions to equity holders, and methods, assumptions and judgements used in estimating the amounts presented or disclosed.

Financial statements are prepared for a specified period of time (the reporting period) and provide information about assets and liabilities (whether recognised or unrecognised) which existed at the end of the reporting period or during it, and income and expenses for the reporting period. Comparative information for at least one preceding reporting period should also be provided.

Information about possible future transactions and other events should be provided if it is useful to users of the financial statements, although information about management's expectations and strategies for the entity is not typically included in the financial statements.

Financial statements are usually prepared on the assumption that the entity is a going concern and will continue to operate for the foreseeable future, although where a decision has been made that the entity will cease trading or enter liquidation, or there is no alternative to such a course of action, a different basis may need to be applied.

In describing the role of financial statements, the 2018 framework states that financial statements are prepared from the perspective of the entity as a whole, instead of from the viewpoint of any particular group of investors, lenders or other creditors.

The framework describes a reporting entity as an entity which is required, or chooses, to prepare general-purpose financial statements. It notes that a reporting entity is not necessarily a legal entity, and could comprise a portion of an entity, or two or more entities.

The framework discusses the boundary of a reporting entity and notes that, in situations where one entity (a parent) has control of another entity (a subsidiary), the boundary of the reporting entity could encompass the parent and any subsidiaries (resulting in consolidated financial statements) or the parent alone (resulting in unconsolidated financial statements). If the reporting entity comprises two or more entities which are not linked by a parent–subsidiary relationship, the reporting entity's financial statements are referred to as "combined financial statements."

Where a reporting entity is not a legal entity and does not comprise only legal entities linked by a parent–subsidiary relationship, determining the appropriate boundary may be difficult. In such cases, the boundary needs to be set in such a way that the financial statements provide the relevant financial information needed by users, and faithfully represent the economic activities of the entity. The boundary should not contain an arbitrary or incomplete set of economic activities, and a description should be provided of how the boundary has been determined.

Where a parent–subsidiary relationship exists, the framework suggests that consolidated financial statements are usually more likely than unconsolidated financial statements to provide useful information to users, but that unconsolidated financial statements may also provide useful information because claims against the parent are typically not enforceable against subsidiaries and in some jurisdictions (for instance, under the UK's Companies Act 2006) the amounts that can legally be distributed to the parent's equity holders depend on the distributable reserves of the parent.

4. The Elements of Financial Statements

This chapter deals with the elements of financial statements, including assets, liabilities, equity, income and expenses. The 2018 framework notes that financial statements provide information about the financial effects of transactions and other events by grouping them into broad classes—the elements of financial statements. The elements are linked to the economic resources and claims, and changes in those economic resources and claims. The related definitions are:

- An *asset* is defined as a present economic resource controlled by the entity as a result of past events. An economic resource is defined as a right that has the potential to produce economic benefits.

- A *liability* is defined as a present obligation of the entity to transfer an economic resource as a result of past events.
- *Equity* is defined as the residual interest in the assets of the entity after deducting all its liabilities.
- *Income* is defined as increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
- *Expenses* are defined as decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

The 2018 framework also identifies other changes in resources and claims, being either contributions from, and distributions to, holders of equity claims, or exchanges of assets or liabilities that do not result in increases or decreases in equity (for example, acquiring an asset for cash).

As with the earlier frameworks, the 2018 framework continues to define income and expenses in terms of changes in assets and liabilities but also notes that important decisions on matters such as recognition and measurement are driven by considering the nature of the resulting information about both financial performance and financial position.

In developing the 2018 framework, the IASB has not addressed the problems which arise in classifying instruments with characteristics of both equity and liabilities. It is considering these matters in its project on financial instruments with the characteristics of equity. The outcomes of that project will assist the IASB in deciding whether it should add a project on amending standards, the conceptual framework or both to its active agenda.

Assets. In relation to the definition of an asset, the chapter discusses three fundamental aspects:

a. rights;
b. the potential to produce economic benefits; and
c. control.

Rights having the potential to produce economic benefits may take many forms, including those corresponding to an obligation of another party (for example, the right to receive cash, goods or services, or the right to exchange economic resources with another party on favourable terms) and those which do not correspond to an obligation of another party (for example, the right to use property, plant and equipment, or intellectual property).

However, not all of an entity's rights are assets of the entity—for an asset to exist, the rights must both have the potential to produce economic benefits to the entity beyond those available to all other parties and be controlled by the entity.

For the potential to produce economic benefits to exist, it need not be certain—or even likely—that the right will produce economic benefits. It is only necessary that the right already exists and that there is at least one circumstance where it would produce economic benefits for the entity beyond those available to all other parties. However, a low probability that economic benefits will be produced may affect the decision on whether to recognise the asset in the financial statements, how it is measured, and what other information is given.

Control links an economic resource to an entity. Control exists if the entity has the present ability to direct the use of the economic resource and obtain the economic benefits that may flow from it. This includes being able to prevent other parties from directing and obtaining in this way. If one party controls an economic resource, then no other party does so. Control usually arises from an ability to enforce legal rights, although this is not always the case. Control could also arise if one party has information or know-how which is not available to any other party and is capable of being kept secret. For control to exist, any future economic benefits from the relevant economic resource must flow directly or indirectly to the entity, and not to another party. However, this does not mean that the entity will be able to ensure that the resource will produce any economic benefits in any circumstances.

Liabilities. In relation to the definition of a liability, the chapter notes that three criteria must all be satisfied:

a. the entity has an obligation;
b. the obligation is to transfer an economic resource; and
c. the obligation is a present obligation that exists as a result of past events.

An obligation is a duty or responsibility that an entity has no practical ability to avoid. An obligation is always owed to another party or parties, but it is not necessary to know the identity of the party or parties to whom the obligation is owed. Many obligations arise from legal commitments (such as contracts or legislative requirements) but an entity may also have obligations (often referred to as "constructive obligations") arising from its customary practices, published policies or specific statements if it has no practical ability to avoid acting in accordance with those practices, policies or statements. An obligation will not exist in any case where there is only an intention on the entity's part to make a transfer of an economic resource, or a high probability that such a transfer will take place, rather than a practically unavoidable requirement upon the entity to make the transfer.

The obligation must have the potential to require the entity to transfer an economic resource to another party or parties. Such transfers include, for example, the payment of cash, the delivery of goods or provision of services, or the exchange of economic resources on unfavourable terms. There need not be certainty that the transfer will take place, only that the obligation exists and that, in at least one circumstance, the entity would be required to transfer an economic resource. For example, the transfer may only become necessary if some specified uncertain future event occurs. However, if the probability of the transfer of an economic resource is low this may affect decisions as to whether the liability is recognised, or simply disclosed, and how it is measured.

For a liability to exist, the obligation must be a present obligation which exists as a result of past events. This will only be the case if the entity has already obtained economic benefits or taken an action, and as a consequence the entity may or will have to transfer an economic resource that it would not otherwise have had to transfer. For example, the entity may have obtained goods and services for which it will later have to make payment, or it may be operating a particular business or in a particular market. The enactment of new legislation may lead to a present obligation, but only where an entity has obtained economic benefits or taken action to which the legislation applies and may, or will as a result, have to transfer an economic resource which it would not otherwise have had to transfer—the enactment of the legislation itself does not give rise to an obligation. In addition, present obligations do not arise from executory contracts—those where neither party has yet undertaken any of its contractual requirements. For example, under an employment contract the entity may be required to pay an employee a salary for services which the employee will provide. No present obligation to pay the salary arises until the entity has received the employee's services. Until then, the entity has a combined right and obligation to exchange future salary for future employee services.

Unit of account. The chapter defines the unit of account as the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which recognition criteria and measurement concepts are applied. The unit of account is selected to provide useful information, which means that information provided about an asset or liability and any related income and expenses must be relevant and must faithfully represent the substance of the transaction or other event from which they have arisen. In determining the appropriate unit of account, it is necessary to consider whether the benefits arising from selecting that unit of account justify the costs of providing and using that information.

Units of account which may be used include:

a. an individual right or individual obligation;
b. all rights, all obligations, or all rights and all obligations, arising from a single source, for example a contract;
c. a subgroup of those rights and obligations, for example a subgroup of rights over an item of property, plant and equipment for which the useful life and pattern of consumption differ from those of the other rights over the item;
d. a group of rights and/or obligations arising from a portfolio of similar items;
e. a group of rights and/or obligations arising from a portfolio of dissimilar items, for example a portfolio of assets and liabilities to be disposed of in a single transaction; and
f. a risk exposure within a portfolio of items—if such a portfolio is subject to a common risk, some aspects of accounting for that portfolio could focus on the aggregate exposure to risk within that portfolio.

Executory Contracts. An executory contract is defined as a contract, or a portion of a contract, that is equally underperformed. Meaning that no party to the contract has performed (fulfilled their obligations) or both parties have partially performed to an equal extent.

Executory contracts establish a combination of rights and obligations to exchange economic resources. The 2018 framework states that these rights and obligations are interdependent and therefore cannot be separated, resulting in a single asset or liability. An asset exits when the contract is favourable and a liability when the contract is unfavourable. Normally, the single inherent assets or liability in an unperformed or equally performed executory contract are not recognised until performance.

The recognition of executory contracts is dependent on the recognition criteria (chapter 5), the measurement basis (chapter 6) and whether the contract is onerous. The basic principle is that executory contracts are not recognised until one party performed, except if it is onerous.

Performance changes the rights and obligations in executory contracts and therefore triggers recognition. For instance, if one party delivers goods, an obligation is created for the other party to pay for the goods. Similarly, if one party makes a prepayment on a purchase contract, the prepayment creates and asset for the party to obtain the goods and a liability for the other to deliver the goods. If both parties have performed fully, the contract is not executory anymore.

Substance of contractual rights and contractual obligations. Financial statements are required to report the substance of the rights and obligations for an entity which arise from a contract to which it is a party. Often, this substance is clear from the legal form of the terms of the contract, but in some cases, it is necessary to analyse the legal terms further to identify the substance of the obligation.

All terms of the contract—whether explicit or implicit—are considered in this analysis, unless the terms have no substance (for example, if they bind neither of the parties, or result in rights which neither party will have the practical ability to exercise under any circumstances).

Where a group or series of contracts are put in place to achieve an overall commercial effect, careful analysis will be necessary to identify the appropriate unit of account, dependent upon the nature of the overall commercial effect. For example, it may be necessary to treat the rights and obligations arising from the group or series of contracts as a single unit of account. On the other hand, if a single contract creates two or more sets of rights and obligations that could have been created through two or more separate contracts, faithful representation may require each set of rights and obligations to be accounted for as though it arose from a separate contract.

Definition of equity. The chapter notes that equity claims are claims on the residual interest in the assets of the entity after deducting all of its liabilities. In other words, equity claims do not meet the definition of a liability. Equity claims fall into different classes, such as ordinary shares and preference shares, which may confer different rights, for example to the receipt of dividends. Business activities are often undertaken through non-corporate entities such as sole proprietorships, partnerships, trusts or government undertakings. The legal frameworks applying to such entities may differ from those which govern corporate entities, but the definition of equity for the purposes of the 2018 framework remains the same in all cases.

Definitions of income and expenses. As already noted, income is defined as increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims. Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

The chapter emphasises that the definitions of income and expenses mean that contributions from holders of equity claims are not income, and distributions to holders of equity claims are not expenses. Income and expenses arise from financial performance. Users of financial statements need information about both an entity's financial position and its financial performance. Therefore, despite income and expenses being defined in terms of changes in assets and liabilities, information about income and expenses is equally important as information about assets and liabilities.

5. Recognition and Derecognition

Recognition. Recognition is the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements—an asset, a liability, equity, income or expenses. An item so recognised is represented in one of the statements by words and a monetary amount, which may be aggregated with other items, and included in one or more of the totals in that statement. The amount at which an item is included in the statement of financial position is referred to as its "carrying amount."

The 2018 framework sets out a recognition process which is based on the linkage between the elements of financial statements, the statement of financial position and the statement(s) of financial performance. This linkage arises from the fact that, in the statement of financial position at the beginning and end of the reporting period, total assets minus total liabilities equal total equity, and recognised changes during the reporting period comprise income minus expenses (recognised in the statement(s) of financial performance, and contributions from holders of equity claims minus distributions to holders of equity claims). Recognition of one item (or a change in its carrying amount) requires the recognition or derecognition (or a change in the carrying amount(s)) of one or more other items. For example, income is recognised in connection with the initial recognition of an asset or the derecognition of a liability. An expense is recognised in connection with the initial recognition of a liability or the derecognition of an asset.

To be recognised in the statement of financial position, an asset, liability or equity must meet the relevant definition. Similarly, only items which meet the definitions of income or expenses will be recognised in the statement(s) of financial performance. However, it should be noted that not all items which meet the definitions will necessarily be recognised. Items meeting the definitions are recognised only if such recognition provides users of financial statements with relevant information about the asset or liability and about any income, expenses or changes in equity, a faithful representation of the asset or liability and of any income, expenses or changes in equity, and information which results in benefits which exceed the cost of providing that information.

Certain circumstances are identified in which recognition of an asset or liability may not provide relevant information to the users of the financial statements. For example, it may be uncertain whether an asset exists or whether an inflow of economic benefits will result from that asset. Similarly, it may be uncertain whether a liability exists or whether an outflow of economic benefits will result. However, there is no clear-cut rule as to whether an item should be recognised under these circumstances and a judgement will need to be made. Even if the item is not recognised it may still be necessary to provide an explanation of the uncertainties associated with it.

Even if recognition of an asset or liability would provide relevant information, it may not provide a faithful representation of that asset or liability and any associated income, expenses or changes in equity. This may be the case if the level of measurement uncertainty inherent in an estimate of the value of the asset or liability is particularly high, although it should be noted that even a high level of measurement uncertainty does not necessarily prevent an estimate from providing useful information. Measurement uncertainty may be especially high in situations where the only way of estimating that measure of the asset is by using cash flow-based techniques and the range of outcomes is exceptionally wide and the probability of each outcome exceptionally difficult to estimate, or the measure is exceptionally sensitive to small changes in estimates of the probability of each possible outcome, or measurement of the asset or liability requires exceptionally difficult or subjective allocations of cash flows which do not relate solely to the asset or liability being measured.

Even in such situations, the framework sets out that the most useful information may be provided by recognising the asset or liability at the amount given by the uncertain estimate, accompanied by a description of the estimate and the uncertainties that surround it. If such information would not provide a sufficiently faithful representation, the most useful information may be provided by a different measure (accompanied by appropriate information and explanations) which is less relevant but subject to lower measurement uncertainty. Only in limited circumstances would the asset or liability not be recognised. Even then, it may still be necessary to include explanatory information about the asset or liability.

Derecognition. Derecognition is the removal of all or part of an asset or liability from an entity's statement of financial position. For an asset, derecognition normally occurs when the entity loses control of all or part of a recognised asset. For a liability, derecognition normally occurs when the entity no longer has a present obligation for all or part of the recognised liability.

The requirements for derecognition set out in the 2018 framework aim to achieve faithful representation both of any assets and liabilities retained after the transaction or other event which led to derecognition (including any item acquired, incurred or created as part of the transaction or other event), and the change in the entity's assets or liabilities as a result of that transaction or other event. Any assets or liabilities which have expired or been consumed, collected, fulfilled or transferred (referred to in the 2018 framework as the "transferred component") will be derecognised, with the associated recognition of any resultant income and expenses. Any assets or liabilities which are retained following the transaction or event (referred to as the "retained component") will continue to be recognised, becoming a separate unit of account from the transferred component—no income or expenses will be recognised on the retained component as a result of the derecognition of the transferred component, unless the transaction or event has caused the measurement basis of the retained component to be amended. Where necessary to achieve a faithful representation, the retained component will be presented separately in the statement of financial position, any income and expenses arising on the derecognition of the transferred component will be presented separately in the statement(s) of financial position, and appropriate explanatory information will be given.

Most decisions about derecognition are straightforward, but complexities can arise, especially where the aims referred to above conflict with each other. The 2018 framework provides detailed guidance on such situations.

In situations where an entity appears to have transferred an asset or liability but the item in fact remains an asset or liability of the entity (for example, legal title to an asset has been transferred but the entity retains significant exposure to variations in the amount of economic benefit which may arise from the asset, or the entity has transferred an asset to a party which holds the asset as agent for the entity) derecognition may not be appropriate because it may not provide a faithful representation of the assets or liabilities retained after the transfer, or of the change in the assets or liabilities of the entity which the transfer has brought about. In such cases, it may be appropriate to continue to recognise the transferred component, with no income or expenses being recognised on either the transferred component or any retained component, any proceeds received or paid being treated as a loan received or advanced, and the transferred component being presented separately in the statement of financial position with an explanation that the entity no longer has any rights or obligations arising from the transferred component. It may also be necessary to provide information about any income or expenses arising from the transferred component after the transfer.

The 2018 framework notes that questions about derecognition often arise when a contract is modified in a way which reduces or eliminates existing rights or obligations. When this occurs, it is necessary to consider which unit of account will provide users of the financial statements with the most useful information about the assets and liabilities retained after the modification, and about how the modification changed the assets and liabilities. If the contract modification only eliminates existing rights or obligations, then the approach described in the paragraph above is followed to determine whether to derecognise those rights or obligations. If the modification only adds new rights or obligations then it will be necessary to decide whether to treat the new rights and obligations as a separate asset or liability, or as part of the same unit of account as the existing rights or obligations. If the modification both eliminates existing rights and obligations, and creates new rights or obligations, both the separate and combined effects of the modification need to be considered. If the substance of the modification is that the old asset or liability has been replaced with a new asset or liability, it may be necessary to derecognise the old asset or liability and recognise the new one.

6. Measurement

Elements recognised in financial statements are quantified in monetary terms. This necessitates the selection of a measurement basis by which to determine the amount to be applied to each element. The most appropriate measurement basis to be applied to any element depends on consideration of the qualitative characteristics of useful financial information relating to that element, and the cost constraint. When selecting a measurement basis, it is important to consider the nature of the information which the measurement basis will produce in both the statement of financial position and the statement(s) of financial performance. The 2018 framework describes several possible measurement bases and notes that standards issued by the IASB may need to describe how to implement whichever measurement basis (or bases) they require.

Measurement bases. Measurement bases are categorised as either historic cost or current values. Four measurement bases are described in the 2018 framework, being historical cost, fair value, value in use (for assets) or fulfilment value (for liabilities), and current cost, alongside a discussion of the information which each basis provides.

Historical cost. The historical cost measure provides financial information about assets, liabilities and their related income and expenses derived essentially from the price of the transaction or other event which gave rise to them. Changes in value of the asset or liability over time are not reflected, except to the extent that an asset has become impaired or a liability has become onerous. The historical cost of an asset when it is acquired or created is the value of the cost incurred in acquiring or creating the asset. This will comprise the consideration paid to acquire the asset plus transaction costs. The historical cost of a liability when it is incurred or taken on is the value of the consideration received to incur or take on the liability minus transaction costs.

If an asset is acquired or created, or a liability incurred or taken on, as a result of an event that is not a transaction on market terms, any cost that it is possible to identify may not provide relevant information about the asset or liability. It may then be necessary to use a current value as the deemed cost at initial recognition, and subsequently treat that deemed cost as the historical cost.

Following initial recognition, the historical cost of an asset is updated over time to take account of consumption of the asset (depreciation or amortisation), payments received that extinguish part or all of the asset, the effect of part or all of the asset becoming unrecoverable (impairment), and the accrual of interest to reflect any financing component of the asset.

Financial assets and liabilities may be measured at historic cost by the application of the amortised cost method. This reflects estimates of future cash flows discounted at a rate determined at initial recognition. Where a financial instrument carries a variable rate of interest, the discount rate is updated to reflect changes in the variable rate. The amortised cost of the financial asset or liability is updated over time to reflect changes such as the accrual of interest, the impairment of a financial asset, and receipts and payments.

Where an asset has been acquired in a recent transaction on market terms, it may be expected that the asset will provide sufficient economic benefit to the entity to recover its cost. Similarly, where a liability has been incurred or taken on in a recent transaction on market terms, it may be expected that the value of the obligation to transfer economic resources to fulfil the liability will be no more than the value of the consideration received minus transaction costs. The measurement of an asset or liability at historical cost in these cases provides relevant information about the asset or liability and the price of the transaction from which it arose.

As the historical cost of an asset is reduced to reflect the consumption of an asset or its impairment, the amount expected to be recovered from the asset is at least as great as its carrying amount. Similarly, because the historical cost of a liability is increased when it becomes onerous, the value of the obligation to transfer economic resources needed to fulfil the liability is no more than the carrying amount of the liability.

Information about margin can be obtained from historical cost measurement, because the expense arising from the sale of an asset is recognised at the same time as the related income (the proceeds of sale). The same holds in respect of the fulfilment of all or part of a liability, where the relevant income is measured as the consideration received for the part fulfilled and is recognised at the same time as the expense incurred in fulfilment.

Information derived about margin in this way may have predictive value, because it can be used to assess the entity's prospects of future net cash flows. Such information may also have confirmatory value, as it may confirm (or otherwise) users' past estimates of cash flows or of margins.

Fair value. Fair value is defined in the 2018 framework as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. It reflects the perspective of participants in a market to which the entity has access.

Fair value can sometimes be determined directly by observing prices in an active market. In other cases, it must be determined indirectly using measurement techniques such as cash flow forecasting, which reflect estimates of future cash flows, possible variations in the amount or timing of those cash flows caused by inherent uncertainty, the time value of money, the price for bearing the inherent uncertainty (in other words, the risk premium or discount), and other factors which market participants would take into account, such as liquidity.

The fair value of an asset or liability is not affected by transaction costs incurred when the asset is acquired, or the liability incurred or taken on. Similarly, it does not reflect the transaction costs which would be incurred on the ultimate disposal of the asset or on the transfer or settlement of the liability.

Information provided by fair value measurement of assets and liabilities may have predictive value, because fair value represents market participants' current expectations about the amount, timing and uncertainty of future cash flows. Such information may also have confirmatory value by providing feedback about previous expectations. Changes in fair value can have a number of different causes, and identifying the effect of each cause may provide useful information.

Income and expenses which reflect market participants' current expectations may have predictive value, because these amounts can be used as inputs in predicting future income and expenses. They may also assist users in assessing management's stewardship of the entity's economic resources.

Value in use (of assets) and fulfilment value (of liabilities). Value in use is defined in the 2018 framework as the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability, including any amounts that the entity expects to be obliged to transfer to other parties besides the liability counterparty to enable it to fulfil the liability.

Because value in use and fulfilment value are based on future cash flows, they do not include transaction costs incurred on acquiring an asset or taking on a liability. However, they do include the present value of any transaction costs the entity expects to incur in ultimately disposing of the asset or fulfilling the liability.

Value in use and fulfilment value are based on entity-specific assumptions, rather than assumptions made by market participants. However, the framework notes that often there is little difference between assumptions made by the entity and those which would be made by market participants.

Value in use and fulfilment value cannot be observed directly and hence are always derived indirectly via cash flow-based measurement techniques, reflecting the same factors as described above for the indirect derivation of fair value.

The value in use of an asset provides information about the cash flows estimated to arise from the use of an asset and, ultimately, its disposal, adjusted to present value. This may have predictive value because it can be used as an input to an assessment of the prospects for future cash flows.

The fulfilment value of a liability provides information about the estimated cash flows needed to fulfil a liability, adjusted to present value. This information may have predictive value.

When estimates of value in use and fulfilment value are updated, the updated amounts may have confirmatory value, because they provide feedback at the accuracy or otherwise of the previous estimates.

Current cost. The current cost of an asset is the cost of an equivalent asset at the measurement date. It includes the consideration that would be paid at the measurement date plus the transaction costs that would be incurred at that date. The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date minus the transaction costs that would be incurred at that date.

Current cost can sometimes be observed directly (for example, if there is an active market in assets of similar age and condition to the asset in question) but where this is not possible (for example, markets deal only in new assets) it would be necessary to derive current cost indirectly by adjusting the price of a new asset to reflect the age and condition of the asset in question.

Similarly to historical cost, current cost provides information about the cost of an asset consumed or about income from the fulfilment of liabilities. Such information can be used to calculate current margins and to predict future margins. In this respect, current cost has the advantage over historical cost in that current cost reflects prices in force at the time of consumption or fulfilment. Where price changes are significant, margins based on current cost may be more useful in predicting future margins than those based on historical cost.

Selection of a measurement basis. Guidance is provided on factors to consider when selecting a measurement basis. It is noted that for the information provided by a particular measurement basis to be useful to the users of the financial statements, it must be relevant, and it must faithfully represent what it purports to represent. Cost is recognised as a constraint on the selection of a measurement basis, as it is with all other areas of financial reporting. The enhancing qualitative characteristics of comparability, verifiability and understandability are also recognised as having implications for the selection of a measurement basis.

Relevance. The relevance of the information provided by a particular measurement basis is affected by the characteristics of the asset or liability being measured, and the contribution of the asset or liability to future cash flows.

Characteristics of the asset or liability being measured. Where the value of an asset or liability is susceptible to market factors or other risks, its historical cost might differ significantly from its current value. Historical cost may therefore not provide relevant information to users of the financial statements if they attach importance to changes in value. For example, historical cost is not an appropriate measurement basis for derivative financial instruments.

In addition, under the historical cost basis, changes in value are not reported at the time of change, but only upon an event such as disposal, impairment or fulfilment. This could lead to an incorrect conclusion by the users of the financial statements that all of the income and expenses recognised at the time of disposal, impairment or fulfilment arose at that point, rather than at the time when the change in value actually occurred.

Where assets or liabilities are measured at fair value, changes in value arise partly from changes in the expectations of market participants and their attitude to risk. The recognition of such changes in value in financial statements may not provide useful information if the entity's intention is to use the assets within its business or fulfil any liabilities itself, rather than selling or transferring them respectively.

Contribution to future cash flows. When an entity's business activity involves the use of several economic resources which produce cash flows indirectly, by being used in combination to produce and market goods or services to customers, historical cost or current cost measurement are likely to provide relevant information about the activity. As described in the sections on historical cost and current cost above, these measurement bases lend themselves to the reporting of margin, which may be the most relevant information to users of the financial statements of entities involved in this type of activity.

Conversely, for assets and liabilities which produce cash flows directly, such as assets which can be sold independently and without significant economic penalty such as disruption to the business, a measurement basis founded upon current value, such as fair value, or value in use (for assets), or fulfilment value (for liabilities), is likely to provide the most relevant information.

Faithful representation. Whether a measurement basis can provide a faithful representation is affected by measurement inconsistency and measurement uncertainty.

Measurement inconsistency. For assets and liabilities which are related in some way, the use of different measurement bases can create measurement inconsistency (or accounting mismatch). Financial statements containing measurement inconsistencies may not faithfully represent some aspects of the entity's financial position and financial performance. Using the same measurement basis for related assets and liabilities may therefore provide users of the financial statements with information which is more useful than if differing measurement bases were used, especially where the cash flows from one asset or liability are directly linked to the cash flows from another asset or liability.

Measurement uncertainty. Measurement uncertainty arises where a measure cannot be determined directly from observation of prices in an active market and must be estimated. Although measures need not be perfectly accurate for a faithful representation to be provided, in some cases the level of measurement uncertainty associated with an estimate may be so high that it would be preferable to select a different measurement basis which would also result in relevant information.

Enhancing qualitative characteristics. The enhancing qualitative characteristics of comparability, understandability and verifiability are relevant to the selection of a measurement basis.

Comparability. Consistent use of the same measurement basis for the same items, either from reporting period to reporting period within the same entity, or for the same reporting period across entities, can make financial statements more comparable.

Understandability. Understandability may be lost as a result of a change in measurement basis. However, there may be a trade-off in terms of an increase in the relevance of the information which the new measurement basis provides. In general, understandability will decline as the number of measurement bases used within a particular set of financial statements increases. Again, however, any loss of understandability may be countered to a degree by an increase in other factors contributing to the usefulness of the information provided.

Verifiability. Verifiability increases where measurement bases are used whose inputs can be independently corroborated either directly, for example by reference to prices in an active market, or indirectly, for example by checking the inputs to a model.

Specific implications of the enhancing qualitative characteristics for particular measurement bases are as follows:

Historical cost. In general, it is straightforward to measure historical cost, and the concept is usually well understood and the measures it produces simple to verify. However, the estimation of the consumption of assets and the measurement of impairment losses or onerous liabilities can be complex and subjective, reducing understandability and verifiability. In addition, identical assets and liabilities which were initially recognised at different times under historical cost may be reported at different amounts, reducing comparability.

Fair value. Because fair value is determined from the point of view of market participants, rather than of the entity, and, as a current value, is unaffected by the date of acquisition of the asset or incurring of the liability, in principle it will be measured at the same amount by entities which have access to the same markets. This will aid comparability. Where fair values are determined directly by observing active markets, the measurement process is simple and easy to understand, in addition to providing measurements which are verifiable. On the other hand, where fair values cannot be measured directly and need to be derived via valuation techniques, the inputs and valuation process may be complex and subjective, reducing comparability, understandability and verifiability.

Value in use (of assets) and fulfilment value (of liabilities). Value in use and fulfilment value always need to be derived via valuation techniques, meaning that comparability, understandability and verifiability may be impaired for the same reasons set out above in relation to fair value. In addition, value in use cannot be determined in a meaningful way for an individual asset used in combination with other assets. In such a case, value in use is determined for the group of assets and then needs to be allocated to individual assets. This process can be subjective and arbitrary, which serves to reduce verifiability. This tends to indicate that value in use is not usually a suitable measurement basis for regular revaluations of assets, but it may be appropriate for occasional remeasurements, for instance where a possible impairment is identified, and it is necessary to determine if the carrying value of an asset is recoverable. Fulfilment value is appropriate for liabilities that do not have a historical cost, such as provisions and insurance liabilities that need to be estimated. Value in use and fulfilment value differs from fair value in that it is entity specific and are therefore not based on market assumptions.

Current cost. Where a current cost basis is used, identical assets or liabilities which are acquired or incurred at different times will be reported in the financial statements at the same amount. This aids comparability. However, the determination of current cost can be a complex, subjective and costly process. An active market may not exist for items of an identical age and condition to those possessed by the entity, meaning that the active market value of new items may need to be adjusted appropriately. It may not even be possible to obtain the price of an identical new asset if these are no longer available due, for example, to advances in technology. In addition, it may be necessary to split current costs changes between the current cost of consumption and the effect of changes in prices, introducing further arbitrary assumptions which may be complex. These aspects may further diminish the verifiability and understandability of current cost measures.

Factors specific to initial measurement. The 2018 framework notes that, where an asset is acquired, or a liability incurred as a result of a transaction on market terms, historical cost will usually be close to fair value, assuming that transaction costs are not significant. Nonetheless, the framework notes that it is important to state the measurement basis which is being applied. In addition, it will usually be appropriate to apply the same measurement basis at initial recognition as will be used for subsequent measurement.

Where initial recognition of an asset or liability occurs as a result of an event which is not a transaction on market terms (for example, as a result of a related party transaction, or where an asset is granted or donated free of charge, or where a liability is imposed by legislation or a court judgement), the framework notes that recognising the asset or liability at its historical cost (which may be zero) may not provide a faithful representation of the entity's assets and liabilities, or the associated income and expenses. In such cases, it may be appropriate to recognise the asset or liability at a deemed cost, with any difference between that amount and any consideration which is given or received being recognised as income or expenses at the time of initial recognition. Careful analysis of such items is needed to ensure that any assets, liabilities and contributions from or distributions to holders of equity claims are recognised, and sufficient explanation is given to achieve a faithful representation of the entity's financial position and financial performance is given.

More than one measurement basis. Situations where more than one measurement basis is needed to provide information about an asset, liability, income or expense are discussed and it is noted that, usually, the most understandable way to provide such information is to use one measurement basis in both the statement of financial position and the statement(s) of financial performance, and to use the other measurement basis for disclosure only. However, in some cases more relevant information may be provided by using a current value measurement basis in the statement of financial position and a different measurement basis to determine the related income or expenses in the statement of profit and loss.

Measurement of equity. The 2018 framework notes that the carrying amount of equity is not measured directly. Instead, it equals the total of the carrying amounts of all recognised assets less the total of the carrying amounts of all recognised liabilities. Because general-purpose financial statements are not intended to show an entity's value, the total carrying amount of equity will not usually equal the aggregate market value of equity claims on the entity, or the amount that could be obtained by selling the entity as a whole on a going concern basis, or the amount that could be obtained by selling all of the entity's assets and settling all of its liabilities.

Despite the fact that total equity is not measured directly, it may be appropriate for certain classes or components of equity to be measured in this way. However, since total equity is already derived as a residual, there will always be at least one class of equity and one component of equity which cannot be measured directly.

Although total equity and each individual class and component of equity are usually positive, it is not impossible for any of these items to be negative in certain circumstances.

Cash flow-based measurement techniques. The 2018 framework provides some commentary on cash flow-based measurement techniques, which may be applied where a measure cannot be observed directly. The framework notes that such techniques are not measurement bases in themselves, but techniques used in applying the selected measurement basis. When using such techniques, it is therefore necessary to identify the measurement basis being applied, and the extent to which the technique reflects the factors applicable to that measurement basis.

Cash flow-based measurement techniques can also be used in applying a modified measurement basis, for example the fulfilment value of a liability modified to exclude the possibility that an entity may fail to fulfil a liability. This may result in information which is more relevant to the users of the financial statements, or that may be less costly to produce or to understand. On the other hand, it is also possible for modified measurement bases to be more difficult for users to understand.

The framework discusses outcome uncertainty and states that this arises from uncertainty about the amount or timing of future cash flows. Such uncertainties are important characteristics of assets and liabilities and need to be taken into consideration in selecting a single amount from the range of possible cash flows. The amount selected for the estimate is usually located in the central part of the range and may be determined by calculating the probability-weighted average (or expected value), the statistical median or the statistical mode. This estimate depends on estimates of future cash flows and possible variations in their amounts or timing but does not take account of any risk premium or discount. In addition to determining the estimate to be recognised in the financial statements in this way, it may be necessary to provide users with information about the range of possible outcomes.

7. Presentation and Disclosure

The 2018 framework discusses presentation and disclosure as communication tools, sets out presentation and disclosure objectives and principles, and deals with classification and aggregation.

Presentation and disclosure as communication tools. The 2018 framework notes that an entity communicates information about its assets, liabilities, equity, income and expenses by presenting and disclosing information in its financial statements. Effective communication in this way makes the information more relevant and contributes to a faithful representation of the entity's assets, liabilities, equity, income and expenses. Effective communication is achieved by focusing on presentation and disclosure objectives and principles rather than rules, classifying information in a way which groups similar items and separates dissimilar items, and aggregating information in such a way that it is not obscured either by unnecessary detail or excessive aggregation. In making a decision on presentation and disclosure, account is taken of whether the benefits provided to users by presenting or disclosing particular information are likely to justify the costs of providing and using that information.

Presentation and disclosure objectives and principles. The 2018 framework states that when the IASB develops presentation and disclosure requirements in standards, it is necessary to achieve a balance between giving entities the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses, and requiring information which is comparable, both from period to period for reporting entities and in a single period across entities.

The framework notes that the inclusion of presentation and disclosure objectives in the IASB's standards supports effective communication, because such objectives assist entities in identifying useful information and deciding how to communicate it in the most effective manner.

The framework also states that entity-specific information is more useful than standardised descriptions (or "boiler-plate"), and duplication of information in different parts of the financial statements is usually unnecessary and can reduce understandability.

Classification. Classification is the sorting of assets, liabilities, equity, income and expenses on the basis of shared characteristics for presentation and disclosure purposes. Such characteristics include, but are not limited to, the nature of the item, its role within the entity's business activities, and how it is measured. Dissimilar items should not be classified together, as this may obscure relevant information, reduce understandability and comparability and may not provide a faithful representation of what it purports to represent.

In general, classification is applied to the unit of account selected for an asset or liability. However, if it would result in the provision of more useful information, it may be appropriate to separate an asset or liability into components which have different characteristics and to classify those components separately. For example, an asset or liability may be separated into current and non-current components, and these components presented accordingly.

Offsetting (the grouping into a single net amount in the statement of financial position of an asset and a liability which have been measured as separate units of account) is usually not appropriate as it classifies dissimilar items together. However, it should be noted that offsetting differs from treating a set of rights and obligations as a single unit of account.

Where equity claims have different characteristics, it may be appropriate to classify them separately. In addition, it may be appropriate to classify components of equity separately if they are subject to particular legal, regulatory or other requirements. For example, in some countries entities are only permitted to make distributions to holders of equity claims if they have sufficient distributable reserves (e.g., under the UK Companies Act 2006), and separate presentation of such reserves may provide useful information.

In relation to information about financial performance, the 2018 framework does not prescribe a single-statement or dual-statement structure for the statement of financial performance. It refers to the statement (or section) of profit and loss as the primary source of information about an entity's financial performance for the period and requires a total (or subtotal) for profit or loss to be provided. Profit or loss is not defined, but it is stated that, in principle, all income and expenses for the period are included in the statement of profit or loss. However, the IASB may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included outside the statement (or section) of profit and loss, in other comprehensive income, when to do so would result in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for the period.

Items of income or expenses included in other comprehensive income in one period will be reclassified into the statement of profit or loss in some future period (i.e., be recycled), if doing so will enhance the relevance of the information included in the statement of profit or loss for that future period, or provide a more faithful representation of the entity's financial performance for that future period. This treatment may not be adopted if, for example, there is no clear basis for identifying the period in which that reclassification would enhance the relevance of the information in the statement of profit or loss, or the amount that should be reclassified.

Aggregation. The 2018 framework states that aggregation is the adding together of assets, liabilities, equity, income and expenses that have shared characteristics and are included in the same classification. Aggregation makes information more useful by summarising a large volume of detail. However, it also conceals some of that detail. There is a trade-off between ensuring that relevant information is not obscured either by excessive insignificant detail or by excessive aggregation. Different levels of aggregation may be appropriate in different parts of the financial statements. For example, the statement of financial position and the statement(s) of financial performance may provide information in a more summarised form than the notes to the financial statements, in which more detail is provided.

8. Concepts of Capital and Capital Maintenance

The material in this chapter has been carried forward unchanged from the 2010 framework, into which it was transferred unchanged from the IASC's 1989 framework. In developing the 2018 framework, the IASB decided that updating the discussion of capital and capital maintenance was not feasible and could have delayed the development of the 2018 framework significantly. On the other hand, the IASB decided that it would be inappropriate for the 2018 framework to exclude a discussion of capital and capital maintenance altogether. The IASB has stated that it may revisit these concepts in the future if it considers it necessary.

Concepts of capital. Two concepts of capital are identified. The most common concept is the financial concept, under which capital is synonymous with the net assets or equity of the entity. Under the alternative concept—the physical concept of capital—capital is regarded as the productive capacity of the entity based on, for example, units of output per day. Selection of the appropriate concept should be based on the needs of the users of the financial statements.

Concepts of capital maintenance and the determination of profit. The two concepts of capital maintenance described above give rise to two corresponding concepts of capital maintenance.

Under financial capital maintenance, a profit is only earned if the monetary amount of the entity's net assets at the end of the reporting period exceeds the monetary amount of its net assets at the beginning of that period, after excluding any distributions to and contributions from owners (in other words, holders of equity claims) during the period. Financial capital maintenance can be measured either in nominal monetary units or units of constant purchasing power.

Under physical capital maintenance, a profit is only earned if the physical productive capacity of the entity (or the resources or funds needed to achieve that capacity) at the end of the reporting period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to and contributions from owners.

The concept of capital maintenance links the concept of capital and the concept of profit because it defines how profit is measured. Profit is the residual following the deduction of expenses from income. If expenses exceed income, then the result is a loss.

Under the financial capital maintenance concept, selection of an appropriate measurement basis depends upon the type of financial capital which the entity is seeking to maintain, for example invested money or invested purchasing power. The physical capital maintenance concept requires the application of the current cost measurement basis.

HIERARCHY OF STANDARDS

The conceptual framework is used by IASB members and staff in their debate, and they expect that those commenting on Exposure Drafts for new or revised standards will articulate their arguments in terms of the conceptual framework. However, the conceptual framework is not normally intended to be used directly by preparers and auditors in determining their accounting methods. IAS 8 has a hierarchy of accounting rules that should be followed by preparers in seeking solutions to accounting problems. This hierarchy says that the most authoritative guidance is IFRS, and the preparer should seek guidance as follows:

1. IAS/IFRS and SIC/IFRIC Interpretations, when these specifically apply to a transaction or condition.
2. In the absence of such a directly applicable standard, judgement is to be used to develop and apply an accounting policy, which conforms to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses set out in the conceptual framework.

3. If this is not possible, the preparer should then look to recent pronouncements of other standard setters which use a similar conceptual framework to develop their standards, as well as other accounting literature and industry practices, which do not conflict with guidance in IFRS dealing with the same or similar circumstances or with the definitions set out in the conceptual framework.

IFRS PRACTICE STATEMENT 1—MANAGEMENT COMMENTARY

Nature and Scope

IFRS Practice Statement *Management Commentary* was issued in December 2010 and is prospectively applicable. The Practice Statement provides a broad, non-binding framework for the presentation of narrative reporting to accompany financial statements prepared in accordance with IFRS. It is therefore not an IFRS standard, and local authorities may voluntarily choose to implement the Practice Statement. However, it is foreseen that many countries will not implement the Practice Statement and will implement the developments regarding integrated reporting instead. Furthermore, many local authorities have similar local guidance.

Management commentary is a narrative report, which provides the context within which the financial position, financial performance and cash flows of an entity need to be interpreted. Management can also explain its objectives and strategies applied to fulfil those objectives. Management commentary falls within the scope of financial reporting, and thus the conceptual framework, and should be read in conjunction with the conceptual framework. The Practice Statement provides the principles, elements and qualitative characteristics of decision-useful information regarding management commentary, and therefore assists management in presenting management commentary.

Management needs to identify the extent of applying the Practice Statement. Full compliance can only be claimed if an entity complies with all the requirements. In applying the Practice Statement, management must consider the needs of the primary users of the financial statements. The primary users are similar to the 2010 conceptual framework: existing and potential investors, lenders and other creditors.

Principles

Management commentary is based on the principles of providing management's view and supplementing and complementing information presented in the financial statements. Management commentary should include forward-looking information and information possessing the qualitative characteristics described in the conceptual framework. Management commentary should present management's perspective and should be derived from the information important to management decision making.

Supplementary and complementary information explains the amounts provided in financial statements and the conditions and events forming that information. It includes all information that is important in understanding the financial statements.

Regarding forward-looking information, it must provide management's perspective regarding the entity's direction. It does not predict the future, but rather focuses on the entity's objectives and strategies to achieve those objectives. Forward-looking information is provided regarding uncertainties, trends and factors, which could influence an entity's revenue, performance, liquidity and capital resources. Forward-looking information is provided through both narrative descriptions and quantitative data and must include disclosures of the assumptions used.

Qualitative Characteristics

The conceptual framework fundamental qualitative characteristics of relevance and faithful representation are applied, and the enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability should be maximised. Management should include all information that is material to its management commentary.

Presentation

The presentation of management commentary should be clear and straightforward. Management commentary should be consistent with the related financial statements, avoid duplication and avoid generic disclosure. To assist in assessing the performance of an entity, management commentary should include the entity's risk exposures, the risk strategies and how effective the strategies are, how resources recognised could affect the financial performance and how non-financial information affects the financial statements.

Elements

The following main elements should be included:

- Nature of business;
- Management's objectives and strategies to achieve the objectives;
- The most significant sources, risks and relationships;
- The results of the entity's operations and prospects; and
- The critical performance measures and indicators used by management to assess the performance against objectives.

A description of the business to understand the entity and its environment is the starting point of management commentary. It includes information about the entity's industry, its market and competition, the legal, regulatory and macroeconomic environment, its main projects, services, business processes and distribution channels, structure and how it creates value.

Objectives and strategies, and changes thereof, must be disclosed in a way which enables users to understand the priorities of the entity and the resources used to achieve them. This includes performance indicators and the time frame over which success is measured. Relationships between objectives, strategies, management actions and executive remuneration are also helpful.

A clear description of the most important resources, risks and relationships which affect the entity's value and how they are managed is needed. This includes analysis of financial and non-financial resources, capital structure, financial needs, liquidity and cash flows and human and intellectual capital. Risk disclosure includes principal risk exposures, changes therein, uncertainties, means of mitigating risks and effectiveness of risk strategies. Risk disclosures could be divided into principal strategic, commercial, operational and financial risks. Significant relationships with stakeholders, which are value driven and managed, should also be disclosed.

A clear description of financial and non-financial performances and prospects should be included. A description of performance and progress during the year helps to predict the future by identifying the main trends and factors affecting the business. Comparison of performance, liquidity and financial position with previous years is essential.

Performance measures and indicators (financial and non-financial) used by management should be disclosed and the reasons why they change over time. This increases the comparability of management commentary over time.

FUTURE DEVELOPMENTS

In May 2021 the IASB issued an Exposure Draft *Management Commentary*. The objective is to create a comprehensive framework for management commentary, which will replace IFRS Practice Note 1.

The IASB also has two projects, which should make future changes to the 2018 Framework: *Financial Instruments with Characteristics of Equity* and *Provisions—Targeted Improvem*ents.

US GAAP COMPARISON

The FASB Concept Statements are herein referred to as the FASB Framework. The FASB Framework consists of different concept statements. Chapters of the new IASB joint framework have also been included in the FASB Concept Statement No. 8 (or CON 8). Both frameworks focus on the asset and liability approach and define assets and liabilities similarly. The IASB Framework only defines two elements of changes in assets and liabilities, namely income and expenses. The FASB Framework identifies more elements such as investments by owners, distributions to owners and other comprehensive income, and subdivides comprehensive income into revenue, expenses, gains and losses. The FASB Framework does not identify probability as a recognition criterion but includes relevance as a recognition criterion. The FASB Framework separates measurement in (1) a selection of the monetary unit, and (2) choice of attribute. Both frameworks provide a list of measurement attributes but provide no guideline on when each should be applied. Neither framework has an adequate concept of the reporting entity.

To provide clarity as to what constitutes a public entity and nonpublic entity under US GAAP, the FASB issued Accounting Standards Update (ASU) 2013-12, *Definition of a Public Business Entity—An Addition to the Master Glossary*, in December 2013 that defines a public business entity. While this ASU does not impact existing requirements, it does provide a singular definition of a public business entity for future financial accounting and reporting guidance. Entities that are not defined as public business entities will be within the scope of the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies*.

While the FASB's conceptual framework project continues, it is no longer a joint project with the IASB. The IASB has pursued advancement of the conceptual framework through the ASAF meetings. The FASB participates in those meetings as a representative of the US.

The FASB has held several meetings over the years on a project entitled Disclosure Framework—Board's Decision Process. The objective and primary focus of the Disclosure Framework project is to improve the effectiveness of disclosures in notes to financial statements by clearly communicating the information that is most important to users of each entity's financial statements. FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting—Chapter 8, *Notes to Financial Statements*, was originally issued in August 2018 and amended in December 2021.

Regarding the IFRS Practice Statement *Management Commentary*, the US Securities and Exchange Commission (SEC) maintains regulations that specify the form and content of management commentary as well as other disclosures.

With respect to going concern under US GAAP, an entity's management should evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). Additionally, management is required to consider plans that are in place to mitigate the risks of an entity's ability to continue as a going concern. If management concludes it is not able to continue as a going concern, it must make specific disclosures. Prior to 2017, US GAAP provided no guidance to management on assessing and disclosing doubts about the ability of the entity to continue as a going concern; however, US auditing and public company regulations did provide such guidance.

3 PRESENTATION OF FINANCIAL STATEMENTS

INTRODUCTION

As set out in IASB's *Conceptual Framework for Financial Reporting 2018*, the objective of general-purpose financial reporting is to provide financial information about the reporting entity which is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Although financial statements prepared for this purpose meet the needs of these specific users, they do not provide all the information which the users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.

In the past, many considered the lack of guidance on the presentation of the financial statements under IFRS to be a significant impediment to the achievement of comparability among financial statements. Users previously expressed concerns that information in financial statements was highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between the financial statements and the financial results and position of the reporting entity.

The revised IAS 1 presented in this chapter resulted from the IASB's deliberations on Phase A of the Financial Statement Presentation project and brings IAS 1 largely into line with the corresponding US standard—Statement of Financial Accounting Standards 130 (FAS 130), *Reporting Comprehensive Income* (codified in ASC 220). The FASB decided that it would not publish a separate standard on this phase of the project but will expose issues pertinent to this and the next phase together in the future. The revised IAS 1 was effective for annual periods beginning on or after January 1, 2009.

In June 2011, the IASB issued an amendment to IAS 1 titled *Presentation of Items of Other Comprehensive Income*, which took effect for annual periods beginning on or after July 1, 2012. The amendment improves the consistency and clarity of items recorded in other comprehensive income. Components of other comprehensive income are grouped together on the basis of whether they are subsequently reclassified to profit or loss or not. The Board highlighted the importance of presenting profit or loss and other comprehensive income together and with equal prominence. The name of the statement of comprehensive income is changed to statement of profit or loss and other comprehensive income.

In December 2014, the IASB issued *Disclosure Initiative (Amendments to IAS 1)*, which made a number of amendments to IAS 1, which took effect for annual periods beginning on or after July 1, 2016. In relation to materiality, the amendments clarify first that information should not be obscured by aggregating or by providing immaterial information, secondly that materiality considerations apply to all parts of the financial statements, and thirdly that even when a standard requires a specific disclosure, materiality considerations do apply. In relation to the Statement of Financial Position and Statement of Profit or Loss and Other Comprehensive Income, the amendments first introduce a clarification that the list of line items to be presented in these statements can be disaggregated and aggregated as relevant and provide additional guidance on subtotals in these statements; and secondly, clarify that an entity's share of other comprehensive income of equity-accounted associates and joint ventures should be presented in aggregate as single line items based on whether or not it will subsequently be reclassified as profit or loss. In relation to the notes to the financial statements, the amendments add additional examples of possible ways of ordering the notes to clarify that understandability and comparability should be considered when determining the order of the notes, and to demonstrate that the notes need not be presented in the order so far listed in IAS 1. The IASB also removed guidance and examples with regard to the identification of significant accounting policies that were perceived as being potentially unhelpful.

IAS 1 is discussed in this chapter, while the structure and content of the financial statements are discussed in Chapter 4, Chapter 5 and Chapter 6.

Sources of IFRS	
Conceptual Framework for Financial Reporting 2010	
IAS 1, 7, 8, 10, 12, 18, 24, 27, 33, 34	*IFRS* 5, 8

SCOPE

IAS 1, *Presentation of Financial Statements*, is applicable to all general-purpose financial statements prepared and presented in accordance with IFRS. IAS 1 is applicable both to consolidated and separate financial statements but is not applicable to the structure and content of interim financial statements (see Chapter 34). The general features of IAS 1 are, however, applicable to interim financial statements.

IAS 1 is developed for profit-orientated entities. Entities with not-for-profit activities or public sector entities may apply the standard, provided that appropriate adjustments are made to particular line items in the financial statements. Entities whose share capital is not classified as equity (such as mutual funds) may also apply IAS 1 provided that the member's interest is appropriately disclosed.

DEFINITIONS OF TERMS

General-purpose financial statements. The financial statements intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs.

Impracticable. Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.

International Financial Reporting Standards (IFRS). Standards and Interpretations issued by the International Accounting Standards Board (IASB), which comprise:

1. International Financial Reporting Standards;
2. International Accounting Standards (issued by the former International Accounting Standards Committee (IASC));
3. Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC); and
4. Interpretations developed by the former Standing Interpretations Committee (SIC).

Material. Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

Notes. Information provided in addition to that presented in the financial statements, which comprise a summary of significant accounting policies and other explanatory information, including narrative descriptions or disaggregation of items presented in those statements as well as information about items which do not qualify for recognition in those statements.

Other comprehensive income. Items of income and expense (including reclassification adjustments) which are not recognised in profit or loss as required or permitted by other IFRS or Interpretations. The components of other comprehensive income include:

1. Changes in revaluation surplus (IAS 16 and IAS 38);
2. Remeasurements of defined benefit plans (IAS 19);
3. Gains and losses arising from translating the financial statements of a foreign operation (IAS 21);
4. Gains and losses on remeasuring of investments in equity instruments designated and financial assets measured at fair value through other comprehensive income (IFRS 9); and
5. The effective portion of gains and losses on hedging instruments in a cash flow hedge (IFRS 9).

Owners. Holders of instruments classified as equity.

Profit or loss. The total of income less expenses, excluding the components of other comprehensive income.

Reclassification adjustments. Amounts reclassified to profit or loss in the current period which were recognised in other comprehensive income in the current or previous periods.

Total comprehensive income. The change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. It comprises all components of "profit or loss" and of "other comprehensive income."

FINANCIAL STATEMENTS

Financial statements are a central feature of financial reporting—a principal means through which an entity communicates its financial information to external parties. The IASB's *Conceptual Framework* (see Chapter 2) describes the basic concepts by which financial statements are prepared. It does so by defining the objective of financial statements; identifying the qualitative characteristics which make information in financial statements useful; and defining the basic elements of financial statements and the concepts for recognising and measuring them in financial statements.

The elements of financial statements are the broad classifications and groupings which convey the substantive financial effects of transactions and events on the reporting entity. To be included in the financial statements, an event or transaction must meet definitional, recognition and measurement requirements, all of which are set out in the *Conceptual Framework*.

How an entity presents information in its financial statements, for example how assets, liabilities, equity, revenues, expenses, gains, losses and cash flows should be grouped into line items and categories and which subtotals and totals should be presented, is of great importance in communicating financial information to those who use that information to make decisions (e.g., capital providers).

Objective

IAS 1 prescribes the basis for presentation of general-purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content. In revising IAS 1, the IASB's main objective was to aggregate information in the financial statements based on shared characteristics. Other sources of guidance on financial statement presentation can be found in IAS 7, 8, 10, 12, 24, 27 and 34, and IFRS 5, 8, 15 and 16.

Purpose of Financial Statements

IAS 1 refers to financial statements as "a structured representation of the financial position and financial performance of an entity" and goes on to explain that the objective of financial statements is to provide information about an entity's financial position, its financial performance and its cash flows, which is then utilised by a wide spectrum of end users in making economic decisions. In addition, financial statements show the results of management's stewardship of the resources entrusted to it. All this information is communicated through a complete set of financial statements which provide information about an entity's:

1. Assets;
2. Liabilities;
3. Equity;
4. Income and expenses, including gains and losses;
5. Contributions by and distributions to owners in their capacity as owners; and
6. Cash flows.

All this information, and other information presented in the notes, helps users of financial statements to predict the entity's future cash flows and their timing and certainty.

GENERAL FEATURES

Fair Presentation and Compliance with IFRS

In accordance with IFRS, financial statements should present fairly the financial position, financial performance and cash flows of an entity. Fair presentation means 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*. As stated in IAS 1, the application of IFRS, with additional disclosure when necessary, should result in financial statements achieving fair presentation. Financial statements should depict financial information without bias for selection or disclosure. However, in extremely rare circumstances where management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements as set out in the *Conceptual Framework*, the entity can depart from that requirement if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure, and the entity discloses all of the following:

1. Management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;
2. The entity has complied with all applicable IFRS, except that it has departed from a requirement to achieve fair presentation;
3. The title of the IFRS from which the entity has departed, the nature of the departure, including the treatment that the IFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the *Conceptual Framework* and the treatment adopted; and
4. For each period presented, the financial effect of the departure on each item in the financial statements which would have been reported in complying with the requirement.

When an entity has departed from a requirement of an IFRS in a prior period, and that departure affects the amounts recognised in the current period, it shall make the disclosures set out in 3 and 4 above.

The standard notes that deliberately departing from IFRS might not be permissible in some jurisdictions, in which case the entity should comply with the standard in question and disclose in the notes that it believes this to be misleading and show the adjustments which would be necessary to avoid this distorted result. In extremely rare circumstances where management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements as set out in the *Conceptual Framework*, but the relevant regulatory framework prohibits departure from the requirement, to the maximum extent possible the entity is required to reduce the perceived misleading aspects of compliance by disclosing all of the following:

1. The title of the IFRS in question, the nature of the requirement and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements as set out in the *Conceptual Framework*; and
2. For each period presented, the adjustments to each item in the financial statements which management has concluded would be necessary to achieve fair presentation.

When assessing whether complying with a specific requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements as set out in the *Conceptual Framework*, management should consider the following:

1. Why the objective of financial statements is not achieved in the circumstances; and
2. How the entity's circumstances differ from those of other entities which comply with the requirement. If other entities in similar circumstances comply with the requirement, there is a rebuttable presumption that the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements as set out in the *Conceptual Framework*.

An entity presenting financial statements in accordance with IFRS must include an explicit and unreserved statement of compliance with all the requirements of IFRS in the notes.

Going concern

When preparing financial statements, management makes an assessment regarding the entity's ability to continue in operation for the foreseeable future, i.e., as a going concern. Financial statements should be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so. If the result of the assessment casts significant doubt upon the entity's ability to continue as a going concern, management is required to disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern. When the financial statements are prepared on the going concern basis it is not necessary to disclose this basis.

Most accounting methods are based on this going concern assumption. For example, the cost principle would be of limited usefulness if we assume potential liquidation of the entity. Using a liquidation approach, fixed assets would be valued at net realisable value (sale price less cost to sell) rather than at amortised cost. The concept of depreciation, amortisation and depletion is justifiable and appropriate only if it is reasonable to assume that the entity will continue to operate for the foreseeable future.

Accrual basis of accounting

Financial statements, except for the statement of cash flows, are to be prepared using the accrual basis of accounting. Under the accrual basis of accounting, an entity recognises the elements of the financial statements (items such as assets, liabilities, income and expenses) when they meet the definition and recognition criteria for those elements in the *Conceptual Framework*. Consequently, transactions and events are recognised when they occur, and they are recorded in the accounting records and presented in the financial statements in the periods when they occur (and not when cash is received or paid). For example, revenues are recognised when earned and expenses are recognised when incurred, without regard to the time of receipt or payment of cash.

Materiality and aggregation

An entity should present separately each material class of similar items as well as present separately material items of a dissimilar nature or function. If a line item is not individually material, it is aggregated with other items either in the financial statements or in the notes. An item which is not considered sufficiently material to justify separate presentation in the financial statements may warrant separate presentation in the notes. It is not necessary for an entity to provide a specific disclosure required by an IFRS if the information is not material.

In general, an item presented in the financial statements is material—and therefore is also relevant—if as a result of omitting, misstating or obscuring it ,would reasonably be expected to influence or change the economic decisions of the primary users made on the basis of the financial statements. Materiality depends on the relative size and nature of the item or error, judged in the particular circumstances. For example, preparers and auditors sometimes adopt the rule of thumb that anything under 5% of total assets or net income is considered immaterial. Although the SEC indicated that a company may use this percentage for an initial assessment of materiality, other factors—quantitative as well as qualitative—must also be considered. For example, the fact that an environmental law (or indeed any law) has been broken could be significant in principle, even if the amount involved is small.

Financial statements are the result of processing, aggregating and classifying many transactions or other events based on their nature or function, and presenting condensed and classified data which are comprised within individual line items. If a line item is not individually material, it can be aggregated either in the financial statements or in the notes (for example, disaggregating total revenues into wholesale revenues and retail revenues), but only to the extent that this will enhance the usefulness of the information in predicting the entity's future cash flows. An entity should disaggregate similar items which are measured on different bases and present them on separate lines; for example, an entity should not aggregate investments in debt securities measured at amortised cost and investments in debt securities measured at fair value.

IFRS Practice Statement 2 *Making Materiality Judgements* was issued in September 2017 for application from September 14, 2017. It provides non-mandatory guidance on making materiality judgements for entities preparing general-purpose financial statements in accordance with IFRS.

The practice statement further notes that information is material if omitting it, misstating or obscuring it could reasonably influence decisions that primary users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.

With the 2018 amendments and the addition of the word 'obscuring' to the definition of materiality widens the scope of the definition to include vague, unclear, scattered, inappropriately aggregated or disaggregated and hidden information.

The need for judgements about materiality is pervasive in the preparation of financial statements. Such judgements apply when making decisions about recognition, measurement, presentation and disclosure. The entity is only required to apply IFRS requirements in these areas when their effect is material.

In making materiality judgements, the entity should consider its own specific circumstances and how the information presented in the financial statements serves the needs of the primary users (defined as existing and potential investors, lenders and other creditors). It is necessary for the entity to consider the types of decision made by the primary users, and what information they need to make those decisions. This in turn leads to consideration of what information is available to primary users from sources other than the financial statements.

The practice statement suggests a four-step process for making materiality judgements:

1. Identify information that has the potential to be material.
2. Assess whether the information identified in Step 1 is, in fact, material.
3. Organise the information within the draft financial statements in a way that communicates the information clearly and concisely to primary users.
4. Review the draft financial statements to determine whether all material information has been identified and materiality considered from a wide perspective and in aggregate, on the basis of the complete set of financial statements.

Identifying information which is potentially material involves considering the requirements of relevant IFRS standards alongside the common information needs of the primary users.

Assessing what is material is judged on the basis of both quantitative and qualitative factors. From the quantitative point of view, this involves considering the size of the impact of transactions, other events or conditions against measures of the entity's financial position, financial performance and cash flows. Qualitative factors are characteristics of transactions, other events or conditions which, if present, make information more likely to influence the decisions of primary users. In judging whether particular items of information are material, it is often necessary to take several factors, both quantitative and qualitative, into account.

Organising information requires classifying, characterising and presenting it clearly and concisely to make it understandable. There is a trade-off between the need to ensure that all material information is included while avoiding unnecessary detail which would hinder understandability.

Finally, a review is necessary to determine whether information is material both individually and in combination with other information included in the financial statements. An item of information which appears to be individually immaterial may nonetheless be material in conjunction with other items presented in the financial statements.

Offsetting

Assets and liabilities, or income and expenses, may not be offset against each other, unless required or permitted by an IFRS. Offsetting in the statement of comprehensive income (or statement of profit or loss, if presented separately) or statement of financial position is allowed in rare circumstances when it more accurately reflects the substance of the transaction or other event. For example, IAS 37 allows warranty expenditure to be netted against the related reimbursement under a supplier's warranty agreement. There are other examples when IFRS "require or permit" offsetting; for example, in IFRS 15 the amount of revenue is reduced by any trade discounts or volume rebates the entity allows. An entity undertakes, in the course of its ordinary activities, other transactions that do not generate revenue but are incidental to the main revenue-generating activities. An entity presents the results of such transactions, when this presentation reflects the substance of the transaction or other event, by netting any income with related expenses arising on the same transaction (see Chapter 20). In addition, an entity can present on a net basis certain gains and losses arising from a group of similar transactions, for example foreign exchange gains and losses or gains and losses on financial instruments held for trading (unless material).

In general, the IASB's position is that offsetting detracts from the ability of users both to understand the transactions and other events and conditions that have occurred, and to assess the entity's future cash flows. However, procedures such as the reduction of accounts receivable by an expected credit loss allowance, or of property, plant and equipment by the accumulated depreciation, are acts which reduce these assets to the appropriate valuation amounts and are not in fact offsetting assets and liabilities.

Frequency of reporting

An entity should present a complete set of financial statements (including comparative information) at least annually. If the reporting period changes such that the financial statements are for a period longer or shorter than one year, the entity should disclose the reason for the longer or shorter period and the fact that the amounts presented are not entirely comparable.

There is a presumption that financial statements will be presented annually, as a minimum. The most common time period for the preparation of financial statements is one year. However, if for practical reasons some entities prefer to report, for example, for a 52-week period, IAS 1 does not preclude this practice.

Comparative information

Unless IFRS permit or require otherwise, comparative information of the previous period should be disclosed for all amounts presented in the current period's financial statements. Comparative narrative and descriptive information should be included when it is relevant to an understanding of the current period's financial statements. As a minimum, two statements of financial position, as well as two statements of comprehensive income, changes in equity, cash flows and related notes, should be presented.

Comparability is the quality of information which enables users to compare the financial statements of an entity through time (i.e., across periods), to identify trends in its financial position and performance, as well as across entities. Comparability should not be confused with uniformity; for information to be comparable, similar elements must look alike and dissimilar elements must look different, and users should be able to identify similarities in and differences between two sets of economic phenomena.

A statement of financial position as at the beginning of the earliest comparative preceding period is required when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items or reclassifies items in its financial statements. Related notes should accompany current and prior year statements of financial position but notes in respect of the opening statement of financial position need not be presented. However, where an entity voluntarily elects to provide an additional statement of financial position, *all* supporting notes for the items included in the statements of financial position must be presented regardless of any changes.

In those limited circumstances, an entity is required to present, as a minimum, three statements of financial position and related notes, as at:

1. The end of the current period;
2. The end of the preceding period (which is the same as the beginning of the current period); and
3. The beginning of the preceding period.

When the entity changes the presentation or classification of items in its financial statements, the entity should reclassify the comparative amounts, unless reclassification is impracticable. In reclassifying comparative amounts, the required disclosure includes:

1. The nature of the reclassification;
2. The amount of each item or class of items that is reclassified; and
3. The reason for the reclassification.

In situations where it is impracticable to reclassify comparative amounts, an entity should disclose:

1. The reason for not reclassifying those amounts; and
2. The nature of the adjustments that would have been made if the amounts had been reclassified.

It should be noted that IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, sets out the adjustments to comparative information needed if changes constitute a change in accounting policy or correction of an error (see Chapter 7).

Note, however, that in circumstances where no accounting policy change is being adopted retrospectively, and no restatement (to correct an error) is being applied retrospectively, the statement of financial position as at the *beginning* of the preceding period included is not required to be presented. Nonetheless, there is no prohibition on doing so.

The related footnote disclosures must also be presented on a comparative basis, except for items of disclosure which would not be meaningful, or might even be confusing, if set out in such a manner. Although there is no official guidance on this issue, certain details, such as schedules of debt maturities as at the end of the preceding reporting period, would seemingly be of little interest to users of the current statements and would largely be redundant when presented alongside information provided for the more recent year end. Accordingly, such details are often omitted from comparative financial statements. Most other disclosures, however, continue to be meaningful and should be presented for all years for which basic financial statements are displayed.

To increase the usefulness of financial statements, many companies include in their annual reports 5- or 10-year summaries of condensed financial information. This is not required by IFRS. These comparative statements allow investment analysts and other interested readers to perform comparative analysis of pertinent information. The presentation of comparative financial statements in annual reports enhances the usefulness of such reports and brings out more clearly the nature and trends of current changes affecting the entity.

Such presentation emphasises the fact that financial statements for a series of periods convey far more understanding than those for a single period and that the accounts for one period are simply an instalment of an essentially continuous history.

Consistency of presentation

The presentation and classification of items in the financial statements should be consistent from one period to the next. A change in presentation and classification of items in the financial statements may be required when there is a significant change in the nature of the entity's operations, another presentation or classification is more appropriate (having considered the criteria of IAS 8), or when an IFRS requires a change in presentation. When making such changes in presentation, an entity should reclassify its comparative information and present adequate disclosures (see *Comparative information* above). Consistency refers to the use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities. Comparability is the goal and consistency is a means of achieving that goal.

STRUCTURE AND CONTENT

Complete Set of Financial Statements

IAS 1 defines a complete set of financial statements as comprising the following:

1. A *statement of financial position* as at the reporting date (the end of the reporting period). The previous version of IAS 1 used the title "balance sheet" and this may still be applied;
2. A *statement of profit or loss and other comprehensive income* for the period (the name "statement of comprehensive income" may still be used):
    a. Components of *profit or loss* may be presented either as part of a single statement of profit or loss and other comprehensive income or in a separate income statement.
    b. A single statement of comprehensive income for the reporting period is preferred and presents all items of income and expense reported in *profit or loss* (a subtotal in the statement of comprehensive income) as well as items of *other comprehensive income* recognised during the reporting period.
    c. However, a separate statement of profit or loss and a separate statement of comprehensive income (two separate statements—dual presentation) may be presented. Under this method of presentation, the statement of comprehensive income should begin with profit or loss and then report items of other comprehensive income.
3. A *statement of changes in equity* for the reporting period;
4. A *statement of cash flows* for the reporting period (the previous version of IAS 1 used the title "cash flow statement," which may still be used);
5. Notes, comprising a summary of significant accounting policies and other explanatory information, including comparative information in respect of the preceding period; and
6. A statement of financial position as at the beginning of the preceding period when the reporting entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements. This requirement is part of the revised IAS 1. (Refer also to *Comparative information* above.)

Financial statements, except for cash flow information, are to be prepared using the accrual basis of accounting. Illustrative examples of the format of the statements of financial position, comprehensive income and changes in equity based on the guidance provided in the appendix to IAS 1 have been provided at the end of this chapter.

The standard provides the structure and content of financial statements and minimum requirements for disclosure on the face of the relevant financial statement or in the notes. These topics are dealt with in the next three chapters (Chapters 4, 5 and 6).

Notes

In accordance with IAS 1, the notes should: (1) present information about the basis of preparation of the financial statements and the specific accounting policies used; (2) disclose the information required by IFRS which is not presented elsewhere in the financial statements; and (3) provide information which is not presented elsewhere in the financial statements but is relevant to an understanding of any of them.

An entity should present notes in a systematic manner and should cross-reference each item in the statements of financial position and of profit or loss and other comprehensive income, or in the separate statement of profit or loss (if presented), and in the statements of changes in equity and of cash flows, to any related information in the notes.

An entity should normally present notes in the following order, to help users to understand the financial statements and to compare them with financial statements of other entities:

1. Statement of compliance with IFRS;
2. Summary of significant accounting policies applied;
3. Supporting information for items presented in the financial statements in the order in which each financial statement and each line item is presented; and
4. Other disclosures, including contingent liabilities and unrecognised contractual commitments, and non-financial disclosures (e.g., the entity's financial risk management objectives and policies).

Statement of compliance with IFRS

IAS 1 requires an entity whose financial statements comply with IFRS to make an explicit and unreserved statement of such compliance in the notes. Financial statements should not be described as complying with IFRS unless they comply with all of the requirements of IFRS.

An entity might refer to IFRS in describing the basis on which its financial statements are prepared without making this explicit and unreserved statement of compliance with IFRS. For example, the EU mandated a carve-out of the financial instruments standard and other jurisdictions have carved out or altered other IFRS standards. In some cases, these differences may significantly affect the reported financial performance and financial position of the entity. This information should be disclosed in the notes.

Accounting policies

The policy note should begin with a clear statement of the nature of the comprehensive basis of accounting used. A reporting entity may only claim to follow IFRS if it complies with every single IFRS in force as at the reporting date. The EU made certain amendments to IFRS when endorsing them (a carve-out from IAS 39), and those EU companies following these directives cannot claim to follow IFRS, and instead will have to acknowledge compliance with IFRS as endorsed by the EU.

Financial statements should include clear and concise disclosure of all material accounting policies that have been used in the preparation of those financial statements. Accounting policy information is regarded to be material if it could influence the decisions of primary users.

Management must also indicate the judgements that it has made in the process of applying the accounting policies that have the most significant effect on the amounts recognised. The entity must also disclose the key assumptions about the future and any other sources of estimation uncertainty which have a significant risk of causing a subsequent material adjustment to need to be made to the carrying amounts of assets and liabilities.

IAS 1 requires an entity to disclose in the summary of significant accounting policies:

1. The measurement basis (or bases) used in preparing the financial statements; and
2. The other accounting policies applied that are relevant to an understanding of the financial statements.

Measurement bases may include historical cost, current cost, net realisable value, fair value or recoverable amount. Other accounting policies should be disclosed if they could assist users in understanding how transactions, other events and conditions are reported in the financial statements.

In addition, an entity should disclose the judgements which management has made in the process of applying the entity's accounting policies and which have the most significant effect on the amounts recognised in the financial statements. Examples of such judgements are when management makes decisions on whether lease transactions transfer substantially all the significant risks and rewards of ownership of financial assets to another party or whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue.

Determining the carrying amounts of some assets and liabilities requires estimation of the effects of uncertain future events on those assets and liabilities at the end of the reporting period. This is likely to be necessary in measuring, for example, the recoverable values of different classes of property, plant and equipment, or the future outcome of litigation in progress. The reporting entity should disclose information about the assumptions it makes regarding the future and other major sources of estimation uncertainty at the end of the reporting period, which have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year. The notes to the financial statements should include the nature and the carrying amount of those assets and liabilities at the end of the period.

Financial statement users must be made aware of the accounting policies used by reporting entities so that they can better understand the financial statements and make comparisons with the financial statements of others. The policy disclosures should identify and describe the accounting principles followed by the entity and methods of applying those principles which materially affect the determination of financial position, results of operations or changes in cash flows. IAS 1 requires that disclosure of these policies be an integral part of the financial statements.

IAS 8 (as discussed in Chapter 7) sets out criteria for making accounting policy choices. Policies should be relevant to the needs of users and should be reliable (representationally faithful, reflecting economic substance, neutral, prudent and complete).

Fairness exception under IAS 1

Accounting standard setters have commonly recognised the fact that even full compliance with promulgated financial reporting principles may, on rare occasions, still not result in financial statements which are accurate, truthful or fair. Therefore many, but not all, standard-setting bodies have provided some form of exception whereby the higher demand of having fair presentation of the entity's financial position and results of operations may be met, even if doing so might require a technical departure from the codified body of GAAP.

In the US, this provision has historically been found in the profession's ethics literature (the "Rule 203 exception"), but under various other national GAAP there was commonly found a "true and fair view" requirement which captured this objective. Under revised IAS 1, an approach essentially identical to the true and fair view requirement (which is codified in the EU's Fourth Directive) has been formalised as well. The rule under IFRS should be narrowly construed, with only the most exceptional situations dealt with by permitting departures from IFRS to achieve appropriate financial reporting objectives.

This matter has been addressed in greater detail above. In the authors' view, having such a fairness exception is vital for the goal of ensuring accurate and useful financial reporting under IFRS. However, extreme caution must be applied in reaching any decision to depart from the formal requirements of IFRS, for example, because these exceptions may not have been transposed into any relevant stock exchange regulations.

Other disclosures required by IAS 1

The reporting entity is required to provide details of any dividends proposed or declared before the financial statements were authorised for issue but not charged to equity. It should also indicate the amount of any cumulative preference dividends not recognised in the statement of changes in equity.

If not otherwise disclosed within the financial statements, the following items should be reported in the notes:

1. The domicile and legal form of the entity, its country of incorporation and the address of the registered office (or principal place of business, if different);
2. A description of the nature of the reporting entity's operations and its principal activities;
3. The name of the parent entity and the ultimate parent of the group; and
4. If it is a limited life entity, information regarding the length of its life.

These disclosures (which have been modelled on those set out by the Fourth and Seventh EU Directives) are of relevance given the multinational character of many entities reporting in accordance with IFRS.

FUTURE DEVELOPMENTS

The IASB has included several projects in the disclosure initiative that might impact IAS 1. Regarding accounting policies disclosures, guidance and examples are developed to explain and demonstrate the application of the "four-step materiality process" of IFRS Practice Statement 2: *Making Materiality Judgements*. A future exposure draft is expected. Guidance is developed to help the IASB in drafting disclosure requirements in IFRS standards and to perform targeted standards-level reviews of disclosure requirements.

In 2021, the IASB issued an Exposure Draft *Disclosure Requirements in IFRS Standards—A Pilot Approach*. A new approach is proposed to develop and draft disclosure requirements in IFRS Standards and new disclosure requirements for IFRS 13 *Fair Value Measurement* and IAS 19 *Employee Benefits* are proposed. The project's name has been renamed to *Disclosure Initiative: Target Standards-level Review of Disclosures*.

In 2021, the IASB also issued an Exposure Draft *Subsidiaries without Public Accountability: Disclosures*, which the IASB proposes would reduce the disclose burden in the financial statements of subsidiaries.

The IASB also released an amendment to the disclosure of accounting policies that are effective from annual reporting periods beginning on or after 1 January 2023. In terms of this amendment only material accounting policies should be disclosed.

ILLUSTRATIVE FINANCIAL STATEMENTS

IAS 1 sets out the format and content of individual financial statements, and minimum requirements for disclosure in the statements of financial position, comprehensive income and changes in equity, as well as other information which may be presented either in the financial statements or in the notes. The illustrative financial statements, prepared based on the guidance provided in the appendix to IAS 1, are presented below. According to the IASB, each entity may change the content, sequencing and format of presentation and the descriptions used for line items to achieve fair presentation in that entity's particular circumstances. For example, the illustrative statement of financial position presents non-current assets followed by current assets, and presents equity followed by non-current liabilities and then by current liabilities (i.e., the most liquid items being presented last), but many entities are used to reversing this sequencing (i.e., the most liquid items being presented first).

The illustrative financial statements show the presentation of comprehensive income in two separate statements—the statement of profit or loss presented separately, followed by the statement of comprehensive income beginning with profit or loss and then reporting items of other comprehensive income. All expenses in the statement of profit or loss are classified by nature. Alternatively, a single statement of profit or loss and comprehensive income could be presented, displaying all items of profit and loss as well as other comprehensive income items in one statement. In addition, expenses could be classified by function instead of by nature.

These examples do not illustrate a complete set of financial statements, which would also include a statement of cash flows, a summary of significant accounting policies and other explanatory information.

Exemplum Reporting PLC
Statement of Financial Position as at December 31, 202X

	202X	**202X-1**
	€	**€**
Assets		
Non-current assets:		
Property, plant and equipment	X	X
Investment property	X	X
Goodwill	X	X
Other intangible assets	X	X
Investments in associates and joint ventures	X	X
Deferred income tax assets	X	X
Financial assets	X	X
	X	X
Current assets:		
Inventories	X	X
Trade receivables	X	X
Other current assets	X	X
Other financial assets	X	X
Cash and cash equivalents	X	X
Non-current assets held for sale	X	X
	X	X
Liabilities		
Current liabilities:		
Trade and other payables	X	X
Current borrowings	X	X
Current portion of long-term borrowings	X	X
Current tax payable	X	X
Finance lease liabilities	X	X
Current provisions	X	X
Liabilities of a disposal group classified as held-for-sale	X	X
Net current assets		
Non-current liabilities:		
Non-current borrowings	X	X
Deferred tax	X	X
Finance lease liabilities	X	X
Non-current provisions	X	X
Retirement benefit obligations	X	X
Net assets		
Equity attributable to equity holders of the parent		
Ordinary shares	X	X
Share premium	X	X
Translation reserve	X	X
Fair value reserve	X	X
Retained earnings	X	X
Equity attributable to owners of the parent	X	X
Non-controlling interest	X	X
Total equity		

The financial statements were approved and authorised for issue by the board and were signed on its behalf on [date]:
Director Signature
Director Name

Exemplum Reporting PLC
Statement of Profit or Loss
For the Year Ended December 31, 202X
(Presentation of comprehensive income in two statements and classification of expenses within profit by nature)

	202X	202X-1
	€	€
Continuing operations		
Revenue	X	X
Other income	X	X
Changes in inventories of finished goods and work in progress	X	X
Work performed by the group and capitalized	X	X
Raw material and consumables used	X	X
Employee benefits expense	X	X
Depreciation and amortisation expense	X	X
Impairment of property, plant and equipment	X	X
Other expenses	X	X
Operating profit	X	X
Investment income	X	X
Finance costs	X	X
Share of profit of associates and joint ventures[1]	X	X
Gain recognised on disposal of interest in former associate	X	X
Profit before tax	X	X
Income tax expense	X	X
Profit for the year from continuing operations	X	X
Profit for the year from discontinued operations	X	X
PROFIT FOR THE YEAR		
Attributable to:		
Equity holders of the parent	X	X
Non-controlling interest	X	X
	X	X
Earnings per share		
From continuing operations		
Basic (cents per share)	X	X
Diluted (cents per share)	X	X
From continuing and discontinued operations		
Basic (cents per share)	X	X
Diluted (cents per share)	X	X

[1]*Share of associates' and joint ventures' profit attributable to owners, after tax and non-controlling interests in the associates.*

Exemplum Reporting PLC
Statement of Profit or Loss and Other Comprehensive Income
For the Year Ended December 31, 202X
(Presentation of comprehensive income in two statements)

	202X	**202X-1**
	€	**€**
PROFIT FOR THE YEAR	X	X
Other comprehensive income:		
Items that will not be reclassified to profit or loss		
Remeasurement of defined benefit pension plans	X	X
Gains on revaluation of property (if revaluation model is used)	X	X
Share of comprehensive income of associates and joint ventures	X	X
	X	X
Items that may be reclassified subsequently to profit or loss		
Exchange differences on translating foreign operations	X	X
Income tax relating to recyclable components of other comprehensive income	X	X
	X	X
Other comprehensive income for the year, net of tax[2]		
Total comprehensive income for the year		
Total comprehensive income attributable to:		
Equity holders of the parent	X	X
Non-controlling interest	X	X

[2] *The income tax relating to each component of other comprehensive income is disclosed in the notes.*

Exemplum Reporting PLC
Disclosure of Components of Other Comprehensive Income
Notes
Year Ended December 31, 202X

	202X		**202X-1**	
	€		**€**	
Other comprehensive income				
Exchange differences on translating foreign operations[3]		X		X
Investments recognised in equity:				
Gains arising during the year	X		X	
Cash flow hedges:				
Gains (losses) arising during the year	X		X	
Less: Reclassification adjustments[4] for gains (losses) included in profit or loss	X		X	
Less: Adjustments for amounts transferred to initial carrying amount of hedged items	X	X	X	X
Gains on property revaluation		X		X

Remeasurement of net defined benefit liability	X	X
Share of other comprehensive income of associates	X	X
Other comprehensive income	X	X
Income tax[5] relating to components of other comprehensive income	X	X
Other comprehensive income for the year	X	X

[3]*There was no disposal of a foreign operation and therefore there is no reclassification adjustment for the years presented.*
[4]*When an entity chooses an aggregated presentation in the statement of comprehensive income, the amounts for reclassification adjustments and current year gain or loss are presented in the notes.*
[5]*The income tax relating to each component of other comprehensive income is disclosed in the notes.*

Exemplum Reporting PLC
Disclosure of Tax Effects Relating to Each Component of Other Comprehensive Income (in Notes)
Year Ended December 31, 202X

	202X			**202X-1**		
	€ *Before-tax amount*	€ *Tax (expense) benefit*	€ *Net-of-tax amount*	€ *Before-tax amount*	€ *Tax (expense) benefit*	€ *Net-of-tax amount*
Exchange differences on translating foreign operations	X	X	X	X	X	X
Investment in equity instruments	X	X	X	X	X	X
Cash flow hedges	X	X	X	X	X	X
Gains on property revaluation	X	X	X	X	X	X
Remeasurement of the net defined benefit liability	X	X	X	X	X	X
Share of other comprehensive income of associates	X	X	X	X	X	X
Other comprehensive income	X	X	X	X	X	X

Exemplum Reporting PLC
Statement of Changes in Equity
For the Year Ended December 31, 202X

	Ordinary shares	Share pre-mium	Trans-lation reserve	Fair value reserve	Revaluation reserve	Retained earnings	Total	Non-controlling interest	Total equity
	€	€	€	€	€	€	€	€	€
Balance at January 1, 202X-1	X	X	X	X	–	X	X	X	X
Changes in equity for 202X-1									
Profit for the year	–	–	–	–	–	X	X	X	X
Exchange differences on translating foreign operations	–	–	X	–	–	–	X	X	X
Gain on revaluation of property (if revaluation model is used)	–	–	–	–	X	–	X	X	X
Available for sale financial assets	–	–	–	X	–	–	X	X	X
Actuarial gains/losses on defined benefit plans	–	–	–	–	–	X	X	–	X
Share of comprehensive income of associates	–	–	–	X	–	–	X	–	X
Total comprehensive income for the year	–	–	X	X	–	X	X	X	X
Dividends	–	–	–	–	–	X	X	X	X
Issue of share capital	X	X	–	–	–	–	X	–	X
Balance at December 31, 202X-1	X	X	X	X	X	X	X	X	X
Balance at January 1, 202X	X	–	–	–	–	–	X	–	X
Changes in equity for 202X									
Profit for the year	–	–	–	–	–	X	X	X	X
Exchange differences on translating foreign operations	–	–	X	–	–	–	X	X	X
Gain on revaluation of property (if revaluation model is used)	–	–	–	–	X	–	X	X	X
Available for sale financial assets	–	–	–	X	–	–	X	X	X
Actuarial gains/losses on defined benefit plans	–	–	–	–	–	X	X	–	X
Share of comprehensive income of associates	–	–	–	X	–	–	X	–	X
Total comprehensive income for the year	–	–	X	X	–	X	X	X	X
Dividends	–	–	–	–	–	X	X	X	X
Issue of share capital	X	X	–	–	–	–	X	–	X
Balance at December 31, 202X	X	X	X	X	X	X	X	X	X

US GAAP COMPARISON

FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements (CON6), which are a basis for US financial reporting and accounting standards, can be viewed online at www.fasb.org and defines 10 interrelated financial statement elements including assets, liabilities and equity which are similar to the IAS definitions. Section 200 of the FASB Accounting Standards Codification (ASC) entitled "Presentation" discusses topics including the balance sheet, statements of shareholder equity, income, comprehensive income and cash flows as well as notes to the financial statements. While no specific examples of financial statement presentation are provided in ASC Section 200, the presentation of financial statements is similar to IAS examples. The format and content for public companies are prescribed by presentation requirements in the respective standards and by SEC rules.

With respect to the use of the going concern assumption, while US GAAP (as amended by ASU 2014–15, *Presentation of Financial Statements—Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern* effective for annual periods ending after December 15, 2016) is an attempt at convergence and now requires management to evaluate and disclose uncertainties about an entity's ability to continue as a going concern, some differences with IFRS remain. In particular, the assessment period under US GAAP is one year after the date that the financial statements are issued (or available to be issued); and US GAAP sets out detailed guidance on the liquidation basis of accounting.

4 STATEMENT OF FINANCIAL POSITION

INTRODUCTION

The statement of financial position (or the balance sheet) is a statement that presents an entity's assets, liabilities and equity (or net assets) at a given point in time (i.e., as at a specific date). During the early era of financial reporting standard setting, throughout the nineteenth century and first half of the twentieth century, the emphasis of legislation was almost entirely on the statement of financial position but by the mid-twentieth century owners were asking for more and more information about operating performance, leading to presentations of an increasingly complex income statement (or the profit and loss).

Since the two financial statements, are linked together because of double entry bookkeeping conventions, they cannot easily serve differing objectives. The stock markets look primarily at earnings expectations, which are largely based on historic performance, as measured by the income statement. If earnings measurement drives financial reporting, this means that, of necessity, the statement of financial position carries the residuals of the earnings measurement process. For example, assets such as motor vehicles with service potential that is used up over several accounting periods will have their costs allocated to these periods through the depreciation process, with the statement of financial position left to report a residual of that allocation process, which may or may not reflect the value of those assets at the end of the reporting period. However, if reporting were truly driven by the statement of financial position, the reporting entity would value the vehicles at the end of each reporting period—for example, by reference to their replacement costs in current condition—and the change in statement of financial position values from one year to another would be reflected in the statement of comprehensive income.

By the 1960s many national GAAP standards were being designed to favour the income statement over the balance sheet, but the pendulum began to swing back to a balance sheet-oriented strategy when standard setters—first the FASB in the US and later others, including the International Accounting Standards Committee, predecessor of the current IASB—developed conceptual frameworks intended to serve as the fundamental theory of financial reporting. Undertaking that exercise had the result of causing accounting theory to revert to its original purpose—namely, to measure economic activity—and implicitly to adopt the definition of income as the change in wealth from period to period. With this in mind, measurement of that wealth, as captured in the balance sheet, became more central to efforts to develop new standards.

In practice, IFRS as currently written are a mixture of both approaches, depending on the transaction being recognised, measured and reported. This mixed attribute approach is partially a legacy of earlier financial reporting rule making, but also reflects the practical difficulties of value measurement for many categories of assets and liabilities. For example, many financial instruments are remeasured at the end of each reporting period, whereas property, plant and equipment are normally held at original cost and are depreciated systematically over estimated useful lives, subject to further adjustment for impairment, as necessary.

Nonetheless, while existing requirements are not entirely consistent regarding financial statement primacy, both the IASB and the FASB, when developing new accounting standards, are now formally committed to a statement of financial position (balance sheet) oriented approach. The IASB's *Conceptual Framework* is expressed in terms of measuring assets and liabilities, and reportedly the two standard-setting bodies and their respective staff analyse transactions affected by proposed standards from the perspective of whether they increase or diminish the assets and liabilities of the entity. Overall, the IASB sees financial reporting as being based on the measuring of assets and liabilities, and has the overall goal of requiring the reporting of all changes to those elements (other than those which are a result of transactions with owners, such as the payment of dividends) in a statement of comprehensive income.

The focus on earnings in the capital markets does not mean that the statement of financial position is irrelevant; clearly the financial structure of the company is an important aspect of the company's risk profile, which in turn is important to evaluating the potential return on an investment from the perspective of a current or potential shareholder. Lenders have an even greater interest in the entity's financial structure. This is why companies sometimes go to great lengths to keep some transactions off the statement of financial position, for example by using special-purpose entities and other complex financing structures. IAS 32 considers that any instrument that gives rise to a right to claim assets from an entity is a liability.

IAS 1 states that "each material class of similar items" should be presented separately in the financial statements. In addition, "items of dissimilar nature or function" should be presented separately, unless they are immaterial. The standard expresses a preference for a presentation based on the current/non-current distinction, but allows a presentation by liquidity if that is more reliable and relevant. An asset or liability is current if it is part of the reporting entity's normal operating cycle (e.g., customer receivables) or if it is expected to be realised or settled within 12 months after the end of the reporting period. Only one of these conditions needs to be satisfied—so, for example, inventory that remains on hand for two years should still be classified as current, while long-term liabilities should be reclassified as current for the final year before settlement. IAS 1 includes a sample of illustrative financial statement structure in its *Guidance on Implementing IAS 1*, but use of this format is optional.

Sources of IFRS	
IAS 1, 8, 10, 24, 32, 36, 38, 40, 41	*IFRS* 5, 6, 7

SCOPE

This chapter discusses the format and content of the statement of financial position by incorporating guidance from the *Conceptual Framework*, IAS 1 and other standards.

DEFINITIONS OF TERMS

The IASB's *Conceptual Framework* describes the basic concepts by which financial statements are prepared. It does so by defining the objective of financial statements; identifying the qualitative characteristics that make information in financial statements useful; and defining the basic elements of financial statements and the concepts for recognising and measuring them in financial statements.

The elements of financial statements are the broad classifications and groupings which convey the substantive financial effects of transactions and events on the reporting entity. To be included in the financial statements, an event or transaction must meet definitional, recognition and measurement requirements, all of which are set out in the *Conceptual Framework*.

The elements of a statement of financial position are:

An asset *is a present economic resource controlled by the entity as a result of past events. (An economic resource is a right that has the potential to produce economic benefits.)*

The following three characteristics must be present for an item to qualify as an asset:

1. The item must provide potential economic benefit, which enables it to deliver future net cash inflows.
2. The entity is able to receive the benefit and restrict other entities' access to that benefit.
3. The event which provides the entity with the right to the benefit has occurred.

In addition, the asset must be capable of being measured reliably. The *Conceptual Framework* states that reliable measurement means that the number must be free from material error and bias and can be depended upon by users to give faithful representation. In the Basis for Conclusions of IFRS 2, the IASB notes that the use of estimates is permitted, and that there may be a trade-off between the characteristics of being free from material error and possessing representational faithfulness.

Assets have features which help to identify them in that they are exchangeable, legally enforceable and have future economic benefit potential. It is this potential which eventually brings cash into the entity and which underlies the concept of an asset.

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

The following three characteristics must be present for an item to qualify as a liability:

1. A liability requires that the entity settle a present obligation by the probable future transfer of an asset on demand or when a specified event occurs or at a particular date.
2. The obligation is to transfer an economic resource.
3. The event that obligates the entity has occurred.

Liabilities are similarly recognised subject to the constraint that they must be able to be measured reliably.

Liabilities usually result from transactions which enable entities to obtain resources. Other liabilities may arise from non-reciprocal transfers, such as the declaration of dividends to the owners of the entity or the pledge of assets to charitable organisations.

An entity may involuntarily incur a liability. A liability may be imposed on the entity by government or by the court system in the form of taxes, fines or levies. A liability may arise from price changes or interest rate changes. Liabilities may be legally enforceable or they may be equitable obligations, which arise from social, ethical or moral requirements. Liabilities continue in existence until the entity is no longer responsible for discharging them.

The diagram which follows, which is taken from one of the statements produced from the conceptual framework project by the US standard setter, the FASB, identifies the three classes of events which affect an entity, and shows the relationship between assets and liabilities, on the one hand, and comprehensive income, on the other.

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

In a business enterprise, the equity is the ownership interest. Equity arises from the ownership relationship and is the basis for distributions of earnings to the owners. Distributions of entity assets to owners are voluntary. Equity is increased by owners' investments and comprehensive income and is reduced by distributions to owners.

In practice, the distinction between equity and liabilities may be difficult to determine. Securities such as convertible debt and certain types of preference shares may have characteristics of both equity (residual ownership interest) and liabilities (non-discretionary future sacrifices). Equity, aside from exchanges with owners, is a residual of the asset/liability recognition model.

Statement of financial position*: a statement of financial position (balance sheet) presents an entity's assets, liabilities and equity as at a specific date.*

GENERAL CONCEPTS, STRUCTURE AND CONTENT

General Concepts

Under IFRS, assets and liabilities are recorded at cost or fair value at inception in the financial statements, which for assets and liabilities arising from arm's-length transactions will generally be equal to negotiated prices. Subsequent measurement is under the historical cost principle or fair value, depending on the requirements of the relevant standard and available accounting policy choices made by the entity. IAS 36, *Impairment of Assets*, requires assets to be reduced in value if their carrying value exceeds the higher of fair value or value in use (expected future cash flows from the asset). IFRS 9, *Financial Instruments*, IAS 40, *Investment Property*, and IAS 41, *Agriculture*, all include some element of subsequent measurement at fair value. Where assets are classified as held-for-sale, they are carried at the lower of their carrying amount or fair value less selling costs (IFRS 5).

Historical exchange prices, and the amortised cost amounts which are later presented, are sometimes cited as being useful because these amounts are objectively determined and capable of being verified independently. However, critics point out that, other than at transaction date, historical cost does not result in presenting, in the statement of financial position, numbers which are comparable between companies so, while they are reliable, they may not be relevant for decision-making purposes. This captures the fundamental conflict regarding accounting information: absolutely reliable or objective information may not be sufficiently relevant to current decision making.

Structure and Content

The titles commonly given to the primary financial statement which presents the state of an entity's financial affairs include the "statement of financial position" or "balance sheet." The revised IAS 1 changed the title of the "balance sheet" to the "statement of financial position," the title used throughout this publication. The IASB concluded that "statement of financial position" better reflects the function of the statement and is consistent with the *Conceptual Framework*. In addition, the title "balance sheet" simply reflected the convention that double entry bookkeeping requires all debits to equal all credits and did not identify the content or purpose of the statement. According to the IASB, the term "financial position" was a well-known and accepted term and had already been used in audit opinions internationally for more than 20 years to describe what the "balance sheet" presents.

The three elements which are always to be displayed in the heading of a statement of financial position are:

1. The name of the entity whose financial position is being presented;
2. The title of the statement; and
3. The date of the statement.

The entity's name should appear exactly as written in the legal document which created it (e.g., the certificate of incorporation, partnership agreement, etc.). The title should also clearly reflect the legal status of the entity as a corporation, partnership, sole proprietorship or division of some other entity.

The statement of financial position presents a "snapshot" of the resources (assets) and claims to resources (liabilities and equity) as at a specific date. The last day of a month is normally used as the statement date (in jurisdictions where a choice is allowed) unless the entity uses a fiscal reporting period always ending on a particular day of the week, such as a Friday or Sunday (e.g., the last Friday in December, or the Sunday falling closest to December 31). In these cases, the statement of financial position can be dated accordingly (e.g., December 26, October 1, etc.). In all cases, the implication is that the statement of financial position captures the pertinent amounts as at the close of business on the date noted.

Statements of financial position should generally be uniform in appearance from one period to the next, as indeed should all of the entity's financial statements. The form, terminology, captions and pattern of combining insignificant items should be consistent. The goal is to enhance usefulness by maintaining a consistent manner of presentation unless there are good reasons to change these and the changes are duly reported.

IAS 1 does not prescribe the sequence or format in which items should be presented in the statement of financial position. Thus, for example, in a standard classified statement of financial position, non-current assets may be presented before or after current assets, and within the current assets, cash can be presented as the first or the last line item. However, the standard stipulates the following list of minimum line items, which are sufficiently different in nature or function to justify separate presentation in the statement:

1. Property, plant and equipment;
2. Investment property;
3. Intangible assets;
4. Financial assets (excluding amounts shown under items 5, 8 and 9);
5. Groups of contracts within the scope of IFRS 17;
6. Investments accounted for using the equity method;
7. Biological assets (within the scope of IAS 41);
8. Inventories;
9. Trade and other receivables;
10. Cash and cash equivalents;
11. The total of assets classified as held-for-sale and assets included in disposal groups classified as held-for-sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*;
12. Trade and other payables;
13. Provisions;
14. Financial liabilities (excluding amounts shown under items 11 and 12);
15. Liabilities and assets for current tax, as defined in IAS 12, *Income Taxes*;
16. Deferred tax liabilities and deferred tax assets, as defined in IAS 12;
17. Liabilities included in disposal groups classified as held-for-sale in accordance with IFRS 5;
18. Non-controlling interests, presented within equity; and
19. Issued capital and reserves attributable to owners of the parent.

The format of the statement of financial position as illustrated by the appendix to IAS 1 is along the following lines:

Exemplum Reporting PLC
Consolidated Statement of Financial Position as at December 31, 202X

	202X	**202X-1**
	€	**€**
Assets		
Non-current assets:	X	X
Property, plant and equipment	X	X
Investment property	X	X
Goodwill	X	X
Other intangible assets	X	X
Investments in associates and joint ventures	X	X
Deferred income tax assets	X	X
Financial assets	X	X

Current assets:	X	X
Inventories	X	X
Trade receivables	X	X
Other current assets	X	X
Other financial assets	X	X
Cash and cash equivalents	X	X
	X	X
Non-current assets held for sale	X	X
	X	X
Liabilities		
Current liabilities:		
Trade and other payables	X	X
Current borrowings	X	X
Current portion of long-term borrowings	X	X
Current tax payable	X	X
Finance lease liabilities	X	X
Current provisions	X	X
	X	X
Liabilities of a disposal group classified as held-for-sale	X	X
Net current assets	X	X
Non-current liabilities:		
Non-current borrowings	X	X
Deferred tax	X	X
Finance lease liabilities	X	X
Non-current provisions	X	X
Retirement benefit obligations	X	X
	X	X
Net assets	X	X
Equity applicable to equity holders of the parent		
Ordinary shares	X	X
Share premium	X	X
Translation reserve	X	X
Fair value reserve	X	X
Retained earnings	X	X
Equity attributable to owners of the parent	X	X
Non-controlling interest	X	X
Total equity	X	X

CLASSIFICATION OF ASSETS

Assets, liabilities and equity are presented separately in the statement of financial position. In accordance with IAS 1, companies should make a distinction between current and non-current assets and liabilities, except when a presentation based on liquidity provides information that is more reliable or relevant. As a practical matter, the liquidity exception is primarily invoked by banks and some other financial organisations, for which fixed investments (e.g., in property and equipment) are dwarfed by financial instruments and other assets and liabilities.

Current Assets

An asset should be classified as a current asset when it satisfies any one of the following:

1. It is expected to be realised in, or is held for sale or consumption in, the normal course of the entity's operating cycle;
2. It is held primarily for trading purposes;
3. It is expected to be realised within 12 months of the end of the reporting period;
4. It is cash or a cash equivalent asset, which is not restricted in its use.

If a current asset category includes items that will have a life of more than 12 months, the amount that falls into the next financial year should be disclosed in the notes. All other assets should be classified as non-current assets if a classified statement of financial position is to be presented in the financial statements.

Thus, current assets include cash, cash equivalents and other assets that are expected to be realised in cash, or sold or consumed during one normal operating cycle of the business. The operating cycle of an entity is the time between the acquisition of materials entering into a process and their realisation in cash or an instrument which is readily convertible into cash. Inventories and trade receivables should still be classified as current assets in a classified statement of financial position even if these assets are not expected to be realised within 12 months from the end of the reporting period. However, marketable securities could only be classified as current assets if they were expected to be realised (sold, redeemed or to mature) within 12 months after the end of the reporting period, even though most would deem marketable securities to be more liquid than inventories and possibly even more liquid than receivables. Management intention takes priority over liquidity potential. The following items would be classified as current assets:

1. *Inventories* held either for sale in the ordinary course of business or in the process of production for such sale, or in the form of materials or supplies to be consumed in the production process or in the rendering of services (IAS 2). The basis of valuation and the method of pricing, which is limited to FIFO or weighted-average cost, should be disclosed.

Inventories—at the lower of cost (FIFO) or net realisable value	X

In the case of a manufacturing concern, raw materials, work in process and finished goods should be disclosed separately on the statement of financial position or in the footnotes.

Inventories	**202X**	**202X-1**
	€	€
Finished goods	X	X
Work in process	X	X
Raw materials	X	X
Total	XX	XX

2. *Receivables*, including accounts and notes receivable, receivables from affiliate companies and officer and employee receivables. The term accounts receivable represents amounts due from customers arising from transactions in the ordinary course of business. Allowances due to expected lack of collectability and any amounts discounted or pledged should be stated clearly. If material, the receivables should be analysed into their component parts. The receivables section may be presented as follows:

Receivables			**202X**	**202X-1**
			€	€
Customer accounts	X			X
Customer notes/commercial paper	X	X		X
Less allowance for expected credit loss		(X)		(X)
			X	X
Due from associated companies			X	X
Due from officers and employees			X	X
Total			X	X

3. *Prepaid expenses*: these are assets created by the prepayment of cash or the incurrence of a liability. They expire and become expenses with the passage of time, use or events (e.g., prepaid rent, prepaid insurance and deferred taxes). This item is frequently aggregated with others on the face of the statement of financial position with details relegated to the notes, since it is often not a material amount.
4. *Trading financial assets*: assets which are acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin. Trading financial assets should be classified as fair value through profit or loss. Trading assets include debt and equity securities and loans and receivables acquired by the entity with the intention of making a short-term profit. Derivative financial assets are always deemed held-for-trading unless they are designated as effective hedging instruments.
5. *Cash and cash equivalents*, including cash in hand, consisting of coins, notes and undeposited cheques; money orders and drafts; and deposits in banks. Anything accepted by a bank for deposit would be considered cash. Cash must be available for withdrawal on demand; thus, assets such as certificates of deposit would not be considered cash because of the time restrictions on withdrawal. Also, to be classified as a current asset, cash must be available for current use. According to IAS 1, cash which is restricted in use and whose restrictions will not expire within the operating cycle, or cash restricted for a non-current use, would not be included in current assets. According to IAS 7, cash equivalents include short-term, highly liquid investments, which are: (1) readily convertible to known amounts of cash, and (2) so near their maturity (original maturities of three months or less) that they present negligible risk of changes in value arising from changes in interest rates. Treasury bills, commercial paper and money market funds are all examples of cash equivalents.

Non-Current Assets

IAS 1 uses the term "non-current" to include tangible, intangible, operating and financial assets of a long-term nature. It does not prohibit the use of alternative descriptions, as long as the meaning is clear. Non-current assets include:

- Financial assets;
- Investment property;
- Property, plant and equipment;
- Intangible assets;
- Assets held for sale; and
- Miscellaneous other assets.

Other Assets

An all-inclusive heading for amounts which do not fit neatly into any of the other asset categories (e.g., long-term deferred expenses, which will not be consumed within one operating cycle, and deferred tax assets).

CLASSIFICATION OF LIABILITIES

Liabilities are normally displayed in the statement of financial position in the order of due dates for payment.

Current Liabilities

According to IAS 1, a liability should be classified as a current liability when:

1. It is expected to be settled in the normal course of business within the entity's operating cycle;
2. It is due to be settled within 12 months of the date of the statement of financial position;
3. It is held primarily for the purpose of being traded; or
4. The entity does not have a right to defer settlement (at the end of a reporting period) beyond 12 months. Note that the terms of a liability that could at the option of the counterparty result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities should be classified as non-current liabilities. Obligations which are due on demand or are callable at any time by the lender are classified as current regardless of the present intent of the entity or of the lender concerning early demand for repayment. Current liabilities also include:

1. Obligations arising from the acquisition of goods and services entering into the entity's normal operating cycle (e.g., accounts payable, short-term notes payable, wages payable, taxes payable and other miscellaneous payables);
2. Collections of money in advance for the future delivery of goods or performance of services, such as rent received in advance and unearned subscription revenues;
3. Other obligations maturing within the current operating cycle, such as the current maturity of bonds and long-term notes.

Certain liabilities, such as trade payables and accruals for operating costs, which form part of the working capital used in the normal operating cycle of the business, are to be classified as current liabilities even if they are due to be settled more than 12 months from the date of the statement of financial position.

Other current liabilities which are not settled as part of the operating cycle, but which are due for settlement within 12 months of the date of the statement of financial position, such as dividends payable and the current portion of long-term debt, should also be classified as current liabilities. However, interest-bearing liabilities which provide the financing for working capital on a long-term basis and are not scheduled for settlement within 12 months should not be classified as current liabilities.

IAS 1 provides another exception to the general rule that a liability due to be repaid within 12 months from the end of the reporting period should be classified as a current liability. If the original term was for a period longer than 12 months and the entity intended to refinance the obligation on a long-term basis prior to the date of the statement of financial position, and that intention is supported by an agreement to refinance, or to reschedule payments, which is completed before the financial statements are approved, then the debt is to be reclassified as non-current as at the date of the statement of financial position.

However, an entity would continue to classify as current liabilities its long-term financial liabilities when they are due to be settled within 12 months, if an agreement to refinance on a long-term basis was made after the date of the statement of financial position. Similarly, if long-term debt becomes callable as a result of a breach of a loan covenant, and no agreement with the lender to provide a grace period of more than 12 months has been concluded by the date of the statement of financial position, the debt must be classified as current.

The distinction between current and non-current liquid assets generally rests upon both the ability and the intent of the entity to realise or not to realise cash for the assets within the traditional one-year time frame. Intent is not of similar significance with regard to the classification of liabilities, however, because the creditor has the legal right to demand satisfaction of a currently due obligation, and even an expression of intent not to exercise that right does not diminish the entity's burden should there be a change in the creditor's intention. Thus, whereas an entity can control its use of current assets, it is limited by its contractual obligations with regard to current liabilities and, accordingly, accounting for current liabilities (subject to the two exceptions noted above) is based on legal terms, not expressions of intent.

Non-Current Liabilities

Non-current liabilities are obligations which are not expected to be settled within the current operating cycle, including:

1. Obligations arising as part of the long-term capital structure of the entity, such as the issuance of bonds, long-term notes and lease obligations;
2. Obligations arising out of the normal course of operations, such as pension obligations, decommissioning provisions and deferred taxes; and
3. Contingent obligations involving uncertainty as to possible expenses or losses. These are resolved by the occurrence or non-occurrence of one or more future events which confirm the amount payable, the payee and/or the date payable. Contingent obligations include such items as product warranties (see the section on provisions below).

For all long-term liabilities, the maturity date, nature of obligation, rate of interest and description of any security pledged to support the agreement should be clearly shown. Also, in the case of bonds and long-term notes, any premium or discount should be reported separately as an addition to or subtraction from the par (or face) value of the bond or note. Long-term obligations which contain certain covenants, which must be adhered to, are classified as current liabilities if any of those covenants have been violated and the lender has the right to demand payment. Unless the lender expressly waives that right or the conditions causing the default are corrected, the obligation is current.

Offsetting Assets and Liabilities

In general, assets and liabilities may not be offset against each other. However, the reduction of accounts receivable by the allowance for expected credit losses, or of property, plant and equipment by the accumulated depreciation, are procedures that reduce these assets by the appropriate valuation amounts and are not in fact the offsetting of assets and liabilities.

Only where there is an actual right of setoff is the offsetting of assets and liabilities a proper presentation. This right of setoff exists only when all of the following conditions are met:

1. Each of the two parties owes the other determinable amounts (although they may be in different currencies and bear different rates of interest);
2. The entity has the right to set off against the amount owed by the other party;
3. The entity intends to offset; and
4. The right of setoff is legally enforceable.

The laws of certain countries, including some bankruptcy laws, may impose restrictions or prohibitions against the right of setoff. Furthermore, when maturities differ, only the party with the nearest maturity can offset because the party with the longer maturity must settle in the manner determined by the earlier maturity party.

The question of setoff is sometimes significant for financial institutions which buy and sell financial instruments, often repackaging them as part of the process. IFRS 9 provides detailed rules for determining when derecognition is appropriate and when financial assets and financial liabilities must be retained on the statement of financial position.

CLASSIFICATION OF SHAREHOLDERS' EQUITY

Shareholders' equity represents the interests of the owners in the net assets of a corporation. It shows the cumulative net results of past transactions and other events affecting the entity since its inception.

Share Capital

This consists of the par or nominal value of preference and ordinary shares. The number of shares authorised, the number issued and the number outstanding should be clearly shown. For preference share capital, the preference features must also be stated, as the following example illustrates:

6% cumulative preference shares, €100 par value, callable at €115, 15,000 shares authorised, 10,000 shares issued and outstanding	€1,000,000
Ordinary shares, €10 par value per share, 2,000,000 shares authorised, 1,500,000 shares issued and outstanding	€15,000,000

Preference share capital that is redeemable at the option of the holder should not be treated as a part of equity—rather, it should be reported as a liability. IAS 32 makes it clear that substance prevails over form in the case of compound financial instruments; any instrument which includes a contractual obligation for the entity to deliver cash is considered to be a liability.

Retained Earnings

This represents the accumulated earnings since the inception of the entity, less any earnings distributed to owners in the form of dividends. In some jurisdictions, notably in continental Europe, the law requires that a portion of retained earnings, equivalent to a small proportion of share capital, be set aside as a legal reserve. Historically, this was intended to limit dividend distributions by young or ailing businesses. This practice is expected to wane, and in any event is not congruent with financial reporting in accordance with IFRS and with the distinction made between equity and liabilities.

Also included in the equity section of the statement of financial position is treasury stock representing issued shares that have been reacquired by the issuer in jurisdictions where the purchase of the entity's own shares and holding in treasury is permitted by law. These shares are generally stated at their cost of acquisition as a reduction of shareholders' equity.

Finally, some elements of comprehensive income, the components of other comprehensive income, are reported in equity. These components of other comprehensive income include net changes in the fair values of financial assets classified at fair value through other comprehensive income, unrealised gains or losses on translations of the financial statements of subsidiaries denominated in a foreign currency, net changes in revaluation surplus, actuarial gains and losses on defined benefit plans, and the effective portion of gains and losses on hedging instruments in a cash flow hedge. In accordance with the revised IAS 1, net changes in all items of other comprehensive income should be reported in a new statement called the "statement of profit or loss and other comprehensive income," and accumulated balances in these items are reported in equity. (For a detailed discussion of the statement of profit or loss and other comprehensive income, refer to Chapter 5.)

Non-controlling interests should be shown separately from owners' equity of the parent company in group accounts (i.e., consolidated financial statements), but are included in the overall equity section.

Disclosure of Share Capital

An entity is required to disclose information which enables the users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. This information should include a description of what the entity manages as capital, and the nature of externally imposed capital requirements, if there are any, as well as how those requirements are incorporated into the management of capital. Additionally, summary quantitative data about what the entity manages as capital should be provided as well as any changes in the components of capital and methods of managing capital from the previous period. The consequences of non-compliance with externally imposed capital requirements should also be included in the notes. All these disclosures are based on the information provided internally to key management personnel.

An entity should also present either in the statement of financial position or in the statement of changes in equity, or in the notes, disclosures about each class of share capital as well as about the nature and purpose of each reserve within equity. Information about share capital should include the number of shares authorised and issued (fully paid or not fully paid); par value per share or that shares have no par value; the rights, preferences and restrictions attached to each class of share capital; shares in the entity held by the entity (treasury shares) or by its subsidiaries or associates; and shares reserved for issue under options and contracts (including terms and amounts).

FUTURE DEVELOPMENTS

In January 2020, IAS 1 was amended to clarify the classification of liabilities as current or non-current. The original effective date of this amendment was for periods beginning 1 January 2022, however, in July 2020 the IASB deferred the effective date to periods beginning 1 January 2023 and in October 2022, this was further deferred to 1 January 2024

In October 2022, the IASB issued the amendment titled *Non-current Liabilities with Covenants*. The proposals address concerns regarding the classification of these liabilities as current or non-current and improves the information provided when an entity's right to defer settlement of a liability for at least twelve months is subject to compliance with certain conditions. The amendment is effective for periods beginning 1 January 2024.

The IASB is exploring targeted improvements to the structure and content of the primary financial statements, with a focus on the statement(s) of financial performance. The IASB is continuing its discussions regarding the December 2019 Exposure Draft *General Presentation and Disclosures*.

US GAAP COMPARISON

Comparative statements are generally accepted but not required by US GAAP. The SEC requires balance sheets for two years. The balance sheet is usually presented in order of liquidity from most or current to least or non-current. This is usually the opposite of the order found under IFRS. US GAAP contains captions for long-term assets and long-term liabilities. The SEC calls for display of a total for current assets and a total for current liabilities, where appropriate, and public companies must comply with the detailed layout requirements of Regulation S-X.

Non-current debt that matures within one year can be classified as non-current if the entity has the intent and ability to refinance the obligation on a long-term basis. Evidence of intent includes:

- Entering into a refinancing agreement for a term of greater than one year, completed before the financial statements are issued or available to be issued; or
- Issuing long-term debt or equity with the purpose of refinancing the short-term debt before the financial statements are issued or available to be issued.

Debt for which there has been a covenant violation may be classified as non-current, if there is a lender agreement to waive the right to demand repayment for more than one year and that agreement exists before the financial statements are issued or available to be issued.

Current portions of deferred tax assets and liabilities must be shown as current. The term "reserve" is discouraged in US GAAP.

5 STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME, AND CHANGES IN EQUITY

INTRODUCTION

The IASB's *Conceptual Framework* emphasises the importance of information about the performance of an entity, which is useful to assess potential changes in the economic resources that are likely to be controlled in the future, predict future cash flows, and form judgements about the effectiveness with which the entity might employ additional resources. For some time from mid-2004, the IASB and FASB collaboratively pursued projects on *Financial Statement Presentation* (originally entitled *Performance Reporting*), which resulted in fundamental changes to the format and content of what is commonly referred to as the income statement (or the profit or loss account). This joint effort was bifurcated. The first phase of the project addressed what constituted a complete set of financial statements and a requirement to present comparative financial statements (absent from US GAAP) and culminated in the issuance of revised IAS 1 in 2007, effective in 2009.

IAS 1, *Presentation of Financial Statements*, as revised in 2007, brings IAS 1 largely into line with the US standard—Statement of Financial Accounting Standards 130, *Reporting Comprehensive Income* (now in Accounting Standards Codification [ASC] 220 *Income Statement—Reporting on Comprehensive Income)*. The standard requires all non-owner changes in equity (i.e., comprehensive income items) to be presented either in one statement of comprehensive income or else in two statements, a separate income statement and a statement of comprehensive income. Components of comprehensive income are not permitted to be presented in the statement of changes in equity as a combined statement of income and comprehensive income became mandatory (or at least preferable); this represented a triumph of the *all-inclusive concept* of performance reporting.

While this approach has been officially endorsed by world standard setters for many decades, in fact, many standards issued over the years have deviated from adherence to this principle. While IAS 1 encourages the presentation of comprehensive income in a single statement, with net income being an intermediate caption, it remains acceptable to instead report in a two-statement format, with a separate income statement and a separate statement of comprehensive income. The statement of comprehensive income will report all non-owner changes in equity separately from owner changes in equity (investments by or distributions to owners).

IAS 1 in its current incarnation thus marks a notable return to an all-inclusive concept of performance reporting, which had been eroded in earlier decades as items such as gains and losses on financial instruments measured at fair value through other comprehensive income and defined benefit plan actuarial gains or losses became reportable directly in the equity section of the statement of financial position—a practice which generated understandable confusion regarding the contents of the reporting entity's "real" results of operations.

Concepts of performance and measures of income have changed over the years, and current reporting still largely focuses on *realised* income and expense. However, *unrealised* gains and losses also reflect real economic transactions and events and are of great interest to decision-makers. Under current IFRS, some of these unrealised gains and losses are *recognised*, while others are *unrecognised*. Both the reporting entities themselves and the financial analyst community go to great lengths to identify those elements within reported income that are likely to continue since expected earnings and cash flows of future periods are the main drivers of share prices.

IFRS rules for the presentation of income are based on a so-called "mixed attribute model." They, therefore, reflect a mixture of traditional realised income reporting, accompanied by fair value measures applied to unrealised gains and losses meeting certain criteria. So, for example, some financial instruments are accounted for differently from property, plant and equipment. Moreover, unrealised gains and losses arising from the translation of the foreign currency-denominated financial statements of foreign subsidiaries do not flow through the income statement. IAS 1 requires that all owner changes in equity should be reported separately from non-owner changes (deriving from performance) in a separate *statement of changes in equity*.

The traditional income statement has been known by many titles. IFRS now refers to this statement as the statement of profit or loss, which reports all items entering into the determination of periodic earnings but excluding other comprehensive income items which are reported in the other comprehensive income section of the statement of profit or loss and other comprehensive income.

For many years, the income statement had been widely perceived by investors, creditors, management, and other interested parties as the single most important part of an entity's basic financial statements. Beginning in the mid-twentieth century, accounting theory development was largely driven by the desire to present a meaningful income statement, even to the extent that the balance sheet sometimes became the repository for balances of various accounts, such as deferred charges and credits, which could scarcely meet any reasonable definitions of assets or liabilities. This was done largely to serve the needs of investors, who are commonly thought to use the past income of a business as the most important input to their predictions of entities' future earnings and cash flows, which in turn form the basis for their estimates of future share prices and dividends.

Creditors look to the statement of profit or loss for insight into the borrower's ability to generate the future cash flows needed to pay interest and eventually to repay the principal amounts of the obligations. Even in the instance of secured debt, creditors do not look primarily to the statement of financial position (balance sheet), in as much as the seizure and liquidation of collateral is never the preferred route to recovery of the lender's investment. Rather, the generation of cash flows from operations—which is generally closely correlated to income—is seen as the primary source for debt service.

Management, then, must be concerned with the statement of profit or loss due to the importance placed on it by investors and creditors. In many large corporations, senior management receives substantial bonuses relating either to profit targets or share price performance. Consequently, management sometimes devotes considerable efforts to massaging what appears in the income statement, to present the most encouraging view of the reporting entity's prospects. This means that standard setters need to bear in mind the possibilities for abuse afforded by the requirements which they put in place. Indeed, many of the requirements have been imposed in response to previous financial reporting abuses.

The importance placed on income measurement has, as is well known, influenced behaviour by some management personnel, who have sought to manipulate results to, for instance, meet market observers' earnings estimates. The motivation for this improper behaviour is readily understandable when one observes that recent markets have severely punished companies that missed earnings estimates by as little as a penny per share. One very popular vehicle for earnings management has centred around revenue recognition. Historically, certain revenue recognition situations, such as that involving prepaid service revenue, have lacked specific financial reporting rules or have been highly subject to interpretation, opening the door to aggressive accounting by some entities. While in many businesses the revenue-earning cycle is simple and straightforward and therefore difficult to manipulate, there are many other situations where it is a matter of interpretation as to when the revenue has been earned. Examples have included recognition by lessors of lease income from long-term equipment rental contracts, which were bundled with supplies and maintenance agreements, and accruals of earnings on long-term construction contracts or software development projects having multiple deliverables.

The information provided by the statement of profit or loss, relating to individual items of income and expense, as well as to the relationships between and among these items (such as the amounts reported as gross margin or profit before interest and taxes), facilitates financial analysis, especially that relating to the reporting entity's historical and possible future profitability. Even with the ascendancy of the statement of financial position as the premier financial statement, financial statement users will always devote considerable attention to the statement of profit or loss.

Sources of IFRS

Conceptual Framework for Financial Reporting 2018

IAS 1, 16, 19, 21, 36, 37, 38, 39, 40 *IFRS* 1, 5, 9, 15 *SIC* 29

SCOPE

This chapter focuses on key income measurement issues and matters of comprehensive income, presentation, and disclosure. It also explains and illustrates the presentation of the *statement of profit or loss and other comprehensive income* and the *statement of changes in equity*. The chapter incorporates information from the *Conceptual Framework for Financial Reporting 2018*, IAS 1, and other standards.

DEFINITIONS OF TERMS

Elements of Financial Statements

Expenses. *Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims*. The term *expenses* is broad enough to include *losses* as well as normal categories of expenses; thus, IFRS differs from the corresponding US GAAP standard (as defined in CON 6), which deems losses to be a separate and distinct element to be accounted for, denoting decreases in equity from peripheral or incidental transactions.

Income. *Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims*. The IASB's *Conceptual Framework* clarifies that this definition of income encompasses both revenue and gains. As with expenses and losses, the corresponding US accounting standard holds that revenues and gains constitute two separate elements of financial reporting, with gains denoting increases in equity from peripheral or incidental transactions (as defined in CON 6).

Other comprehensive income. *Items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRS*. The components of other comprehensive income include: (1) changes in revaluation surplus (IAS 16 and 38); (2) actuarial gains and losses on defined benefit plans (IAS 19); (3) translation gains and losses (IAS 21); (4) gains and losses on remeasuring of equity instrument financial assets (IFRS 9); and (5) the effective portion of gains and losses on hedging instruments in a cash flow hedge (IFRS 9).

Profit or loss. The total of income less expenses, excluding the components of other comprehensive income.

Reclassification adjustments. Amounts reclassified to profit or loss in the current period that were recognised in other comprehensive income in the current or preceding periods.

Statement of changes in equity. As prescribed by IAS 1, an entity should present, as a separate financial statement, a statement of changes in equity showing:

1. Total comprehensive income for the period (reporting separately amounts attributable to owners of the parent and non-controlling interest);

2. For each component of equity, the effect of retrospective application or retrospective restatement recognised in accordance with IAS 8;
3. The amounts of transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners; and
4. A reconciliation for each component of equity (each class of share capital and each reserve) between the carrying amounts at the beginning and the end of the period, separately disclosing each movement.

Statement of profit or loss and other comprehensive income. The statement of profit or loss and other comprehensive income presents all components of "profit or loss" and "other comprehensive income" in a single statement, with net income being an intermediate caption. IAS 1 alternatively permits the use of a two-statement format, with a separate statement of profit or loss and a separate statement of comprehensive income.

Total comprehensive income. The change in equity (net assets) of an entity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in net assets during a period, except those resulting from investments by owners and distributions to owners. It comprises all components of "profit or loss" and "other comprehensive income" presented in the statement of comprehensive income.

Other Terminology

Additional comparative information. Narrative and descriptive comparative information in addition to the minimum comparative information required by IFRS.

Component of an entity. In the context of discontinued operations, IFRS 5 currently defines a component of an entity as operations and cash flows that can be distinguished, operationally and for financial reporting purposes, from the rest of the entity—a cash-generating unit, or group of cash-generating units.

Discontinued operations. IFRS 5 defines a "discontinued operation" as a component of an enterprise that has been disposed of, or is classified as held-for-sale, and:

1. Represents a separate major line of business or geographical area of operations;
2. Is part of a single coordinated disposal plan;
3. Is a subsidiary acquired exclusively with a view to resale.

Minimum comparative information. Narrative and descriptive information in respect of the preceding period for all amounts reported in the current period's financial statements where it is relevant to an understanding of the current period's financial statements.

Net assets. Net assets are total assets minus total liabilities (which is thus equivalent to owners' equity).

Operating segment. A component of an entity: (1) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity); (2) whose operating results are regularly reviewed by the entity's chief operating decision-maker to make decisions about resources to be allocated to the segment and assess its performance; and (3) for which discrete financial information is available.

Realisation. The process of converting non-cash resources and rights into money, or more precisely the sale of an asset for cash or claims to cash.

Recognition. The process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements—an asset, a liability, equity, income or expenses. Recognition involves depicting the item in one of those statements—either alone or in aggregation with other items—in words and by a monetary amount and including that amount in one or more totals in that statement.

CONCEPTS OF INCOME

Economists have generally employed a wealth maintenance concept of income. Under this concept, income is the maximum amount that can be consumed during a period and still leave the entity with the same amount of wealth at the end of the period as existed at the beginning. Wealth is determined with reference to the current market values of the net productive assets at the beginning and end of the period. Therefore, the economists' definition of income would fully incorporate market value changes (both increases and decreases in wealth) in the determination of periodic income and this would correspond to measuring assets and liabilities at fair value, with the net of all the changes in net assets equating to comprehensive income.

Accountants, on the other hand, have traditionally defined income by reference to specific transactions which give rise to recognisable elements of revenue and expense during a reporting period. The events which produce reportable items of revenue and expense comprise a subset of economic events that determine economic income. Many changes in the market values of wealth components are deliberately excluded from the measurement of accounting income but are included in the measurement of economic income, although those exclusions have grown fewer as the use of fair values in financial reporting has been more widely embraced in recent years.

This can be seen in IFRS 9, where the changes in the market value of some financial instruments are recognised, and in IAS 41, where the change in the value of biological assets is recognised even though not realised.

RECOGNITION AND MEASUREMENT

Income

According to the IASB's *Conceptual Framework*:

> *Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.*

The definition of income encompasses both revenue and gains, and revenue arises in the course of ordinary activities of an enterprise and is referred to by different names, such as sales, fees, interest, dividends, royalties, and rent.

IFRS 15 is the standard that deals with accounting for revenue. IFRS 15, *Revenue from Contracts with Customers*, states that revenue is income arising in the course of an entity's ordinary activities.

IFRS 15 requires that when (or as) a performance obligation is satisfied; an entity shall recognise as revenue the amount of the transaction price that is allocated to that performance obligation and goes on to set out detailed requirements for determining the transaction price. IFRS 15 and revenue recognition are discussed in detail in Chapter 20.

Expenses

According to the IASB's *Conceptual Framework*:

> *Expenses are decreases in assets, or incurrences in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.*

Expenses are expired costs or items that were assets but are no longer assets because they have no future value. Costs such as materials and direct labour consumed in the manufacturing process are relatively easy to identify with the related revenue elements. These cost elements are included in the inventory and expensed as cost of sales when the product is sold and revenue from the sale is recognised. This is associating cause and effect.

Some costs are more closely associated with specific accounting periods. In the absence of a cause and effect relationship, the asset's cost should be allocated to the benefiting accounting periods systematically and rationally. This form of expense recognition involves assumptions about the expected length of benefit and the relationship between benefit and cost of each period. Depreciation of property, plant and equipment, amortisation of intangible assets, and allocation of rent and insurance are examples of costs that would be recognised by the use of a systematic and rational method.

All other costs are normally expensed in the period in which they are incurred. This would include those costs for which no clear-cut future benefits can be identified, costs that were recorded as assets in prior periods but for which no remaining future benefits can be identified, and those other elements of administrative or general expense for which no rational allocation scheme can be devised. The general approach is first to attempt to match costs with the related revenues. Next, a method of systematic and rational allocation should be attempted. If neither of these measurement principles is beneficial, the cost should be immediately expensed.

Gains and Losses

The *Conceptual Framework* defines the term *expenses* broadly enough to include losses. IFRS includes no definition of gains and losses that enables them to be separated from income and expenses. Traditionally, gains and losses are thought by accountants to arise from sales and purchases outside the regular business trading of the company, such as on disposals of non-current assets which are no longer required. IAS 1 used to include an extraordinary category for the presentation of items that were clearly distinct from ordinary activities. The IASB removed this category in its 2003 Improvements Project, concluding that these items arose from the normal business risks faced by an entity and that it is the nature or function of a transaction or other event, rather than its frequency, which should determine its presentation within the statement of comprehensive income.

Gains and losses represent increases and decreases in economic benefits and as such are no different in nature from income and expenses. Hence, they are not regarded as separate elements in IASB's *Conceptual Framework*. Characteristics of gains and losses include the following:

1. They result from peripheral transactions and circumstances that may be beyond an entity's control.
2. They may be classified according to sources or as operating and non-operating.

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

IAS 1 states that comprehensive income is the change in the entity's net assets throughout the reporting period arising from non-owner sources. An entity has the option of presenting comprehensive income in a period either in one statement (the single-statement approach) or in two statements (the two-statement approach). The IASB initially intended to mandate the single-statement approach for the statement of comprehensive income, but during discussions with constituents, many of them were opposed to the concept of a single statement, stating that it could result in an undue focus on the "bottom line" of the statement. Consequently, the IASB decided that presentation in a single statement was not as important as its fundamental decision that all non-owner changes in equity should be presented separately from owner changes in equity. Nonetheless, the IASB has indicated that it prefers a one-statement approach. If an entity presents the components of profit or loss in a separate statement, this separate statement of profit or loss (income statement) forms part of a complete set of financial statements and should be presented immediately before the statement of comprehensive income.

Although IAS 1 uses the terms "profit or loss," "other comprehensive income" and "total comprehensive income," an entity may use other terms to describe the totals, as long as the meaning is clear. For example, an entity may use the term "net income" to describe profit or loss.

Comprehensive income comprises all components of "profit or loss" and of "other comprehensive income."

Total comprehensive income for the period reported in a statement of profit or loss and other comprehensive income is the total of all items of income and expense recognised during the period (including the components of profit or loss and other comprehensive income).

Other comprehensive income is the total of income less expenses (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other IFRS or Interpretations.

The statement of profit or loss and other comprehensive income must in addition to the information given in the profit and loss and other comprehensive income sections disclose the following totals:

1. Profit or loss;
2. Total other comprehensive income;
3. Comprehensive income for the year (total of 1. and 2.).

IAS 1 stipulates that, in addition to items required by other IFRS, the profit and loss section of the statement of profit or loss and other comprehensive income must include line items that present the following amounts for the period (if they are pertinent to the entity's operations for the period in question):

1. Revenue, presenting separately interest revenue calculated using the effective interest method;
2. Gains and losses arising from the derecognition of financial assets measured at amortised cost;
3. Finance costs;

4. Impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with Section 5.5 of IFRS 9;
5. Share of the profit or loss of associates and joint ventures accounted for by the equity method;
6. If a financial asset is reclassified out of the amortised cost measurement category so that it is measured at fair value through profit or loss, any gain or loss arising from the difference between the previous amortised cost of the financial asset and its fair value at the reclassification date (as defined in IFRS 9);
7. If a financial asset is reclassified out of the fair value through other comprehensive income measurement category so that it is measured at fair value through profit or loss, any cumulative gain or loss previously recognised in other comprehensive income that is reclassified to profit or loss;
8. Tax expense;
9. A single amount for the total of discontinued operations.

In addition, an entity should disclose the following items on the face of the statement of profit or loss and other comprehensive income as allocations:

1. Profit or loss for the period attributable to:
   a. Non-controlling interest; and
   b. Owners of the parent.
2. Total comprehensive income for the period attributable to:
   a. Non-controlling interest; and
   b. Owners of the parent.

If an entity presents profit or loss in a separate statement, it should present items 1–9 listed above and allocation of profit or loss attributable to non-controlling interest and owners of the parent (listed in 1 above) on the face of that statement.The foregoing items represent the barest acceptable minimum of detail in the statement of profit or loss and comprehensive income. The standard states that additional line items, headings, and subtotals should be presented on the face of the statement when this is relevant to an understanding of the entity's financial performance. This requirement cannot be dealt with by incorporating the items into the notes to the financial statements. When items of income or expense are material, disclosures identifying their nature and amount are required in the statement of profit or loss and comprehensive income or in the notes.

PRESENTATION IN THE STATEMENT OF PROFIT OR LOSS

In accordance with IAS 1, if an entity presents the components of profit or loss in a separate statement of profit or loss, this separate statement should be displayed immediately before the statement of comprehensive income. The following also needs to be disclosed.

Statement Title

The legal name of the entity must be used to identify the financial statements and the correct title used to distinguish the statement from other information presented in the annual report.

Reporting Period

The period covered by the statement of profit or loss must be clearly identified, such as "Year ended December 31, 2017" or "Six months ended September 30, 2017." Income statements are normally presented annually (i.e., for a period of 12 months or a year). However, in some jurisdictions, they may be required at quarterly or six-monthly intervals, and in exceptional circumstances (such as a newly acquired subsidiary aligning its accounting dates with those of its new parent), companies may need to prepare a statement of profit or loss for periods exceeding one year or shorter periods as well. IAS 1 requires that when financial statements are presented for periods other than a year, the following additional disclosures should be made:

1. The reason for presenting the statement of profit or loss (and other financial statements, such as the statement of cash flows, statement of changes in equity, and notes) for a period other than one year; and
2. The fact that the comparative information presented (in the statement of profit or loss, statement of changes in equity, statement of cash flows, and notes) is not entirely comparable.

Entities whose operations form a natural cycle may have a reporting period that ends on a specific day of the week (e.g., the last Friday of the month). Certain entities (typically retail enterprises) may prepare income statements for a fiscal period of 52 or 53 weeks instead of a year (thus, to always end on a day such as Sunday, on which no business is transacted, so that inventory may be taken). These entities should clearly state that the income statement has been presented, for instance "for the fifty-two-week period ended March 25, 2020." IAS 1 notes that it is unlikely that the financial statements presented in this way would be materially different from those which would be presented for a full year.

So that the presentation and classification of items in the statement of profit or loss are consistent from period to period, items of income and expenses should be uniform in both appearance and categories from one period through to the next. If a decision is made to change classification schemes, the comparative prior period financial statements should be restated to conform and thus to maintain comparability between the two periods being presented together. The disclosure must be made of this reclassification, since the earlier period financial statements being presented currently will differ in appearance from those nominally same statements presented in the earlier year.

Comparative Information

As a minimum, comparative figures regarding the previous reporting period should be included. The requirements apply for both the profit or loss section and the other comprehensive income section.

Classification of Expenses

An example of the income statement (profit or loss) classification by the "nature of expense" method is shown below:

Exemplum Reporting PLC
Statement of Profit or Loss
For the Year Ended December 31, 202X
(Classification of expense by nature)

	€	€
Revenue		X
Other income		X
Changes in inventories of finished goods and work in progress	X	
Work performed by the entity and capitalised	X	
Raw material and consumables used	X	
Employee benefits expense	X	
Depreciation and amortisation expense	X	
Impairment of property, plant and equipment	X	
Other expenses	X	
Total expenses		X
Operating profit		X

An example of the income statement (profit or loss) classification by the "function of expense" method is as follows:

Statement of Profit or Loss
For the Year Ended December 31, 202X
(Classification of expense by function)

	€
Revenue	X
Cost of sales	X
Gross profit	X
Other income	X
Distribution costs	X
Administrative expenses	X
Other expenses	X
Operating profit	X

Under the "function of expense" method an entity should report, at a minimum, its cost of sales separately from other expenses. This method can provide more relevant information to the users of the financial statements than the classification under the "nature of expense" method but allocating costs to functions may require arbitrary allocations based on judgement.

IAS 1 furthermore stipulates that if a reporting entity discloses expenses by function, it must also provide information on the nature of the expenses, including depreciation and amortisation and staff costs (salaries and wages). The standard does not provide detailed guidance on this requirement, but entities need only provide a note indicating the nature of the allocations made to comply with the requirement.

IFRS 5 governs the presentation and disclosures on discontinued operations. This is discussed later in this chapter. While IAS 1 does not require the inclusion of subsidiary schedules to support major captions in the statement of profit or loss and other comprehensive income, it is commonly found that detailed schedules of line items are included in full sets of financial statements. These are illustrated below to provide a more expansive discussion of the meaning of certain major sections of the statement of profit or loss and other comprehensive income.

Companies typically show their regular trading operations first and then present any items to which they wish to direct users' attention.

1. *Sales or other operating revenues* are charges to customers for the goods and/or services provided to them during the period. This section of the statement of profit or loss and other comprehensive income should include information about discounts, allowances, and returns to determine net sales or net revenues.
2. *Cost of goods sold* is the cost of the inventory items sold during the period. In the case of a merchandising entity, net purchases (purchases less discounts, returns, and allowances plus freight-in) are added to the beginning inventory to obtain the cost of goods available for sale. From the cost of goods available-for-sale amount, the ending inventory is deducted to compute the cost of goods sold.

   A manufacturing enterprise computes the cost of goods sold in a slightly different way. The cost of goods manufactured would be added to the beginning inventory to arrive at cost of goods available for sale. The ending finished goods inventory is then deducted from the cost of goods available for sale to determine the cost of goods sold. The cost of goods manufactured is computed by adding to raw materials on hand at the beginning of the period the raw materials purchased during the period and all other costs of production, such as labour and direct overheads, thereby yielding the cost of goods placed in production during the period. When adjusted for changes in work in process during the period and raw materials on hand at the end of the period, this result in the cost of goods produced.
3. *Operating expenses* are primary recurring costs associated with central operations, other than the cost of goods sold, which are incurred to generate sales. Operating expenses are normally classified into the following two categories:

   a. Distribution costs (or selling expenses);
   b. General and administrative expenses.

   Distribution costs are those expenses related directly to the entity's efforts to generate sales (e.g., sales salaries, commissions, advertising, delivery expenses, depreciation of store furniture and equipment, and store supplies). General and administrative expenses are expenses related to the general administration of the company's operations (e.g., office salaries, office supplies, depreciation of office furniture and fixtures, telephone, postage, accounting, and legal services, and business licenses and fees).
4. *Other revenues and expenses* are incidental revenues and expenses not related to the central operations of the company (e.g., rental income from letting parts of premises not needed for company operations).

5. *Separate disclosure items* are items that are of such size, nature, or incidence that their disclosure becomes important to explain the performance of the enterprise for the period. Examples of items that, if material, would require such disclosure are as follows:

    a. Write-downs of inventories to net realisable value, or of property, plant and equipment to recoverable amounts, and subsequent reversals of such write-downs;
    b. Costs of restructuring the activities of an enterprise and any subsequent reversals of such provisions;
    c. Costs of litigation settlements;
    d. Other reversals of provisions.

6. *Income tax expense*. The total of taxes payable and deferred taxation adjustments for the period covered by the income statement.
7. *Discontinued operations*. IFRS 5 was issued by the IASB as part of its convergence programme with US GAAP.

IFRS 5 created a new "held-for-sale" category of asset into which assets, or "disposal groups" of assets and liabilities that are to be sold, are classified. Such assets or groups of assets are to be valued at the lower of carrying amount and fair value less any selling costs. Any resulting write-down appears, net of tax, as part of the caption "discontinued operations" in the statement of profit or loss and other comprehensive income.

The other component of this line is the post-tax profit or loss on discontinued operations. A discontinued operation is defined as a component of an entity that has either been disposed of or has been classified as held-for-sale. It must also:

- Be a separate major line of business or geographical area of operations;
- Be a part of a single coordinated plan for disposal; or
- Be a subsidiary acquired exclusively with a view to resale.

The two elements of the single line in the statement of profit or loss and other comprehensive income have to be analysed in the notes, breaking down the related income tax expense between the two, as well as showing the components of revenue, expense, and pre-tax profit of the discontinued operations.

For the asset or disposal group to be classified as held-for-sale, and its related earnings to be classified as discontinued, IFRS 5 states that the sale must be highly probable, the asset must be saleable in its current condition, and the sale price must be reasonable in relation to its fair value. The appropriate level of management in the entity must be committed to a plan to sell the asset and an active programme must have been embarked upon. The sale should be expected within one year of classification and the standard sets out stringent conditions for any extension of this, which are based on elements outside the control of the entity.

Where an operation meets the criteria for classification as discontinued but will be abandoned within one year rather than be sold, it should also be included in discontinued operations. Assets or disposal groups categorised as held-for-sale are not depreciated further.

Example of a schedule of cost of goods sold

Exemplum Reporting PLC
Schedule of Cost of Goods Sold
For the Year Ended December 31, 202X

		€	€	€
Beginning inventory				X
Add:	Purchases		X	
	Freight-in		X	
Cost of purchases			X	
Less:	Purchase discounts	X		
Purchase returns and allowances		X	(X)	
Net purchases				X
Cost of goods available for sale				X
Less:	Ending inventory			(X)
Cost of goods sold				X

Example of schedules of cost of goods manufactured and sold

Exemplum Reporting PLC
Schedule of Cost of Goods Manufactured
For the Year Ended December 31, 202X

	€	€
Direct materials inventory, January 1	X	
Purchases of materials (including freight-in and deducting purchase discounts)	X	
Total direct materials available	X	
Direct materials inventory, December 31	(X)	
Direct materials used		X
Direct labour		X
Factory overhead:		
Depreciation of factory equipment	X	
Utilities	X	
Indirect factory labour	X	
Indirect materials	X	
Other overhead items	X	X
Manufacturing cost incurred in 202X		X
Add: Work in progress, January 1		X
Less: Work in progress, December 31		(X)
Cost of goods manufactured		X

Exemplum Reporting PLC
Schedule of Cost of Goods Sold
For the Year Ended December 31, 202X

	€
Finished goods inventory, January 1	X
Add: Cost of goods manufactured	X
Cost of goods available for sale	X
Less: Finished goods inventory, December 31	(X)
Cost of goods sold	X

Example of disclosure of discontinued operations under IFRS 5

Exemplum Reporting PLC
Statement of Income
For the Year Ended December 31, 202X

	202X	**202X-1**
	€	**€**
Continuing operations (segments X and Y):		
Revenue	X	X
Operating expenses	(X)	(X)
Pre-tax profit from operating activities	X	X
Interest expense	(X)	(X)
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit after taxes	X	X
Discontinuing operations (segment Z):		
Discontinued operations (note)	(X)	X
Total enterprise:		
Profit (loss) attributable to owners	X	X
The relevant note is as follows:		
Discontinued operations		
Revenue	X	X
Operating expenses	(X)	(X)
Provision for end-of-service benefits	(X)	–
Interest expense	(X)	(X)
Pre-tax profit	X	X
Income tax	(X)	(X)
Discontinued earnings	X	X
Impairment loss	(X)	(X)
Income tax	X	X
Write-down of assets held for sale, net	(X) (X)	(X) (X)