CHAPTER 2
THE FINANCIAL REPORTING SYSTEM

Quick test

Question 1

High quality financial information implies credible, transparent, understandable information that faithfully represents the financial affairs of an entity. It is needed to enable all the stakeholders in the entity to make informed decisions. They need to be able to identify risks and uncertainties, compare the performance of a company over time and the performance of different companies and to assess the stewardship of a company. It is important that stakeholders know to whom they give their money and trust and what the company is doing with it. Current and potential investors and lenders will be able to make better decisions on whether to invest in companies. Potential investors will decide whether to purchase a company's shares whereas current investors will make decisions on whether to buy more shares, sell, or maintain the same level of investment in a company. Lenders will decide whether to provide loan capital to companies and the level of return they require.

The higher the quality the information the more confidence investors and lenders will have in the information and the decisions they make based on this. Comparability between companies and sectors is needed, and this will be easier with high quality information. This will assist in the liquidity of the markets and enable the most efficient allocation of resources. This, in turn, will have an effect on individuals and society as pension funds, insurance companies and other institutional investors will make better investment choices.

For companies, high quality information can lower their cost of capital, as the risks for investors which originate from the uncertainties of future earnings will be reduced. It will also encourage competition as organisations can better understand and react to their competitors' activities.

Question 2

Explain why neutrality is a key ingredient of high quality financial reporting.

Neutrality is an inherent element of financial information being true and fair, which is the overarching requirement of financial statements. It means that there is no bias in the accounting, and preparers should be objective in selecting accounting policies and methods, and not choose ones which lead to more favourable information – for example, the presentation of an inflated profit figure, or an exaggerated provision for doubtful debts, which will produce a lower profit figure. Where opinions and judgement are required to determine accounting policies or methods, the ones chosen should represent an entity's economic position fairly and faithfully and not be skewed. If they are neutral, financial reports should disclose all relevant information about items and transactions, and not contain only that which may portray the entity in a better light.

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Neutrality implies consistency in accounting methods so that a company's performance over time and different companies' results can be compared. It helps prevent short-termism and earnings management, both of which mean that profits may be manipulated for the benefit of the company or those that run it.

How might non-neutral financial information be harmful to investors?

Investors will be harmed from biased information because it may lead to them making choices which do not meet their objectives. If information is biased, investors will lose trust and confidence in financial reports and face increased risk and take longer in making decisions. Such transactions costs will have adverse effects on the economy as a whole because it will lead to the inefficient allocation of resources.

It must be noted however that neutrality is practically impossible to achieve in a principles based financial reporting system. Financial reports include many items that require the preparer's judgement which may be highly subjective in certain areas. For example, depreciation, accrual accounting, provisions and inventory valuation all require judgement as does the greater use of fair values in financial measurement. Different individuals will have differing opinions on the appropriate way to account for and measure such items. Disclosures of where judgement has been applied, with possible sensitivity analyses, therefore become very important for users to evaluate the impact.

Can financial information be both neutral and prudent?

Prudence has been an underpinning concept of financial accounting and reporting for many years. (For example, the UK ASB's SSAP 2 published in the 1970s included four underpinning concepts, one of which was prudence.) It was seen as necessary to counter management's natural bias towards optimism, and has underpinned many accounting methods and is ingrained in some way in many existing financial reporting standards.

The 2010 *Conceptual Framework* removed references to prudence in the qualitative characteristics because the IASB considered that the term could be interpreted in ways that were inconsistent with neutrality. However many have called for the reinstatement of prudence ever since. The current ED of the *Framework* now includes references to prudence within its discussion of faithful representation.

The ED states that neutrality is supported by the exercise of prudence. Cautious prudence applies where judgements have to be made under conditions of uncertainty. In these cases caution should be exercised so that assets and income are not overstated and liabilities and expenses are not understated. This is not the same as allowing for the deliberate understatement of assets and income and the deliberate overstatement of liabilities and expenses.

However the application of prudence can also result in losses or liabilities being recognised at an earlier stage than gains or assets are – referred to as asymmetric prudence. This interpretation of prudence is certainly included in a number of financial reporting standards, e.g. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see Chapter 13) which requires different recognition thresholds for contingent liabilities and contingent assets. Is this consistent with neutrality?

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The IASB's argument is that companies should select neutral accounting policies and apply them in a neutral way. The accounting policies selected should provide relevant and faithfully representative information – and this may result in asymmetric prudence. However the IASB rejects the requirement to apply asymmetric prudence in all circumstances, e.g. prohibiting the recognition of all unrealised gains resulting from the measurement of assets or liabilities at market prices. Relevant information may be lost if strict adherence to this interpretation were to be applied.

Develop your understanding

Question 3

The IASB sets out the objective of financial reporting as decision-usefulness in its *Conceptual Framework for Financial Reporting* (2010 and 2015 Exposure Draft):

> 'The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments and providing or settling loans and other forms of credit.'

Thus the primary objective of financial reporting is about taking decisions about resource allocation in the market place, and the information provided must be useful for these purposes.

Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, for example dividends, principal and interest payments or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity.

The emphasis on future cash flows leads to the idea that '... each non-cash asset represents future cash receipts, each liability represents expected future cash outlays, and each revenue and expense represents a change in an asset or liability or a current cash receipt or outlay' (FASB, 1976, p.54). Thus financial statements which report market (fair) values (which are often based on discounted cash flows), and their changes will increase their decision-relevance, and will help individual shareholders make better forecasts of future cash flows.

The two amended chapters of the 2010 *Conceptual Framework*, namely, The Objectives of Financial Reporting and The Qualitative Characteristics of Financial Reporting, were

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completed as a result of a convergence project between the IASB and the US FASB. Both the IASB's and the FASB's previous frameworks focussed on providing information that is useful in making economic decisions as the fundamental objective of financial reporting, but for a wide pool of users. The converged objectives, focussing on investors' and lenders' needs, were perceived as being more influenced by the FASB, as in the US financial reporting is much more influenced by the capital markets and their regulators rather than the law or independent standard setters.

A more traditional view of the objective of financial reporting stems from agency theory, whereby a principal (the owners/shareholders) appoint an agent (management/the directors) to run a business. The principal requires the agent to report and be accountable to him for the resources he has entrusted. This leads to the objective of financial reporting being about stewardship. The financial statements are therefore based on information to evaluate the returns from the historical values of the resources that are entrusted as opposed to future cash flows which they may bring in.

Some considered that the IASB's objectives of financial reporting ignored stewardship, and focussed too much on decision-usefulness with its emphasis on the provision of information for the prediction of future cash flows. These critics also stated that capital providers take other sorts of decision, for example, shareholders vote on whether to retain directors or replace them, and on how members of management should be remunerated for their services. The investors need information on which to base these decisions.

The IASB's 2010 *Conceptual Framework* did include explanations of how stewardship is important as a part of the decision-usefulness objective:

> 'To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.' (IASB, 2010, OB4)

In other words, information designed for resource allocation decisions would also be useful for assessing management's performance.

The IASB explained that it did not use the term 'stewardship' because of the difficulties in translating it into other languages.

In its 2015 Exposure Draft (ED) the IASB has responded to the critics, and made much more explicit reference to stewardship in the actual *Framework*. Indeed the second paragraph dealing with the objectives of financial reporting now includes:

> 'Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, for example dividends, principal and interest payments or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the

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> amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity ***and their assessment of management's stewardship of the entity's resources***. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity make those assessments.' (IASB, 2015, 1.3)

Additional reference to stewardship is now included throughout the objectives chapter. Thus it can be seen that the IASB considers that both assessing prospects for future cash flow and assessing the quality of management's stewardship are important for making decisions about providing resources to an entity, and information about stewardship is important for resource providers, who have the ability to vote on, or otherwise influence, management's actions.

Question 4

Financial reporting standards are part of the financial reporting process, and as important as other parts in ensuring high quality financial reporting. One of the overriding requirements of users is to be able to compare financial reports of an entity over time or to compare those of different entities. Prior to the introduction of financial reporting standards, companies' financial reporting was based on 'best practice', with many variations, particularly in areas where choice was possible (e.g. depreciation) or which required judgement (e.g. inventory valuation). Underpinning concepts and principles (e.g. accruals, substance over form, neutrality) by themselves were insufficient to ensure that the accounting was comparable. This is even more so the case with some of today's complex financial transactions. Financial reporting standards are designed to ensure that companies experiencing similar events account for them in a similar manner and disclose the same sort of details; ensuring users are able to compare the outcomes.

Financial reporting standards are the 'rule-book' of accounting and specify the methods of accounting and disclosures required for different transactions and items. They cover when items should be recognised and the measurement (valuation) methods that should be applied. In some cases (e.g. property, plant and equipment) choices may still exist in the accounting methods; however full disclosures of these choices then have to be made. Courts now accept that financial statements which follow financial reporting standards are deemed to be fairly stated (i.e. give a 'true and fair' view) which is the overriding legal requirement in the UK. However, financial reporting standards are based on underpinning concepts – international financial reporting standards are based on the IASB's *Conceptual Framework* – and should always be applied with this in mind.

As indicated above, high quality financial reporting relies on a sequence of processes, with financial reporting standards being one part of this system. Companies themselves should have good and reliable financial accounting systems and internal controls, one of which would be the internal audit function. The company's audit committee has responsibility for the integrity of the financial reporting of the company, and has to be properly structured and be able to exercise sound controls and take appropriate decisions. There has to be good corporate governance within the company to ensure the directors set an ethical culture and act properly and with integrity. The financial reporting standards used in the preparation of the financial statements need to be high quality to ensure good

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reporting. Finally the external audit has to be of high quality both in the procedures followed and in the use of ethical and honest personnel. These processes are all inter-related, and rely on each other to ensure a properly functioning high quality financial reporting system.

Question 5

The IASB's *Conceptual Framework* is the underpinning to all international financial reporting. The 2015 Exposure Draft sets out its purpose as follows:

(a) To assist the International Accounting Standards Board (IASB) to develop Standards that are based on consistent concepts;
(b) To assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction or event, or when a Standard allows a choice of accounting policy; and
(c) To assist all parties to understand and interpret the Standards.

Its aim is therefore to assist all involved in the financial reporting process from preparers of financial information, through auditors to users and to accounting standard setters.

The 2015 ED of the *Conceptual Framework* sets out and defines the fundamental building blocks and principles of financial reporting, namely:

1. The objective of financial reporting
   The purpose and nature of financial statements, the principle users, and the purpose for which they use financial statements
2. The qualitative characteristics of financial information – in other words, what makes financial information useful to users
   If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of the information is enhanced if it is comparable, verifiable, timely and understandable.
3. Performance can be measured on the accruals basis and on a cash basis, and both are useful to users
4. The underpinning concept of going concern is assumed
5. The definition of the reporting entity
6. The definition, recognition, derecognition and measurement of the elements from which financial statements are constructed – assets, liabilities, equity, income and expenses
7. Principles of presentation and disclosure
8. Concepts of capital and capital maintenance

It therefore sets out the principles which should be applied for any financial item that is not covered by a published financial reporting standard to ensure that the overriding objectives of financial reporting are met. Since they are based on the details contained in the *Framework*, as financial reporting standards are developed, there should also be consistency between different standards. Without such a framework, financial reporting standards dealing with the detail of different issues may end up inconsistent and contradictory. The *Framework* as a basis also means that the financial reporting

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standards themselves do not need to contain so much detail and contributes to the principles-based nature of the standards. Definitions and explanations of the qualitative characteristics will ensure that the information contained within financial reports is useful for all users, and provide them with confidence that the information they are reading gives a true and fair view of the company.

Question 6

'Substance over form' implies that items are accounted for according to their economic or commercial substance rather than their legal form. There is no standard or explicit definition of this in any accounting standard, but the definitions of assets and liabilities in the 2015 Exposure Draft of the IASB's *Conceptual Framework* are based on the substance approach:

Asset – 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.

Liability – a present obligation of the entity to transfer an economic resource as a result of past events.

The definition of an asset makes no mention of legal ownership being required for an asset to be recognised as such. Evidence of control is where the benefits and risks that are similar to those that come with ownership are present – therefore the item should be accounted for as if it were a resource. An example of this is an asset that is used in a business but is leased rather than being legally owned. IFRS 16 *Leases* requires that the assets and related lease obligations of arrangements where the right to control the use of an asset by the customer (the lessee), i.e. the right to obtain substantially all of the economic benefits from the use of the asset and the right to direct the use of the identified asset, are included as assets and liabilities on the lessee's statement of financial position.

The definition of a liability again makes no mention of a legal or contractual obligation for a liability to be recognised. The expected transfer of economic resources is all about the commercial result of a transaction or item, and may in fact only be an obligation because of custom and practice. Examples of such liabilities include where a company replaces or repairs its faulty products even if it is contractually not required to do so. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires the expected costs relating to this service to be treated as a liability. Redeemable preference shares are another example of a liability being recognised despite their legal form being share capital.

IAS 1 includes the requirement that financial statements should be fairly stated. This is generally taken to be equivalent to the UK's legal 'true and fair' requirement. These terms also have no explicit definition, but are taken to mean, *inter alia*, that financial statements should show all net resources that the enterprise uses to generate the profits/losses; be comprehensive; must fully reflect all transactions undertaken; use proper and appropriate valuation methods and explain these; where estimates and judgements are required these must be reasonable and if necessary explained; be timely; and satisfy the key users' requirements to make economic decisions.

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Fairly stated financial statements should therefore include all resources controlled, and all obligations where there will be an expected transfers of resources. This ties in with the 'substance over form' definitions of assets and liabilities detailed above. Furthermore, legal opinion has indicated that financial statements which are prepared using international financial reporting standards, which are based on the substance over form concept, *prima facie* give a true and fair view (although the true and fair override is permitted in the rare circumstance of the application of a particular accounting standard being misleading in some way).

Take it further

Question 7

(a) The purpose of the IASB's *Conceptual Framework* is to assist the IASB, other standard setters, preparers, auditors and users of financial statements and any other party interested in the work of the IASB. The 2015 Exposure Draft specifically sets out its aims:

- To assist the International Accounting Standards Board (IASB) to develop Standards that are based on consistent concepts;
- To assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction or event, or when a Standard allows a choice of accounting policy; and
- To assist all parties to understand and interpret the Standards.

The *Conceptual Framework* is issued by the IASB, which takes its authority as part of the IFRS Foundation, a not-for-profit, private-sector body that is funded by a range of global stock market participants. Financial reporting standards and authoritative statements, including the *Conceptual Framework*, issued by the IASB are accepted by stock market regulators as requirements for companies listing on the markets.

The *Framework* is not a financial reporting standard. It cannot override the requirements of IASs and IFRSs. However it underpins all standards, and provides the conventions and principles on which they are built. Standards should therefore not be in conflict with it.

It has developed over time, as financial reporting objectives and methods have had to develop with business practices. The current version of it (the 2010 version) contains two sections, the objectives of financial reporting and qualitative characteristics of useful financial information, which were published as a result of a convergence project between the IASB and the US FASB. The remaining sections are from the IASB's 1989 *Principles for the Preparation and Presentation of Financial Information*, which are therefore rather out of date and actually inconsistent with some more recent financial reporting standards.

In 2012 the IASB commenced work on a project to finally complete their revision of the *Conceptual Framework*, and in May 2015 published an Exposure Draft of a revised *Framework*. Since then, the IASB has carried out much consultation and deliberation,

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and although expected publication dates for the new *Framework* have passed, the IASB considers it important to get this right. Some have criticised the fact that the convergence project has not yet been completed despite many financial reporting standards being issued in the intervening period. They have questioned those standards which use accounting methods based on principles and concepts not actually specified in the *Framework*. However, once complete, the *Framework* should gain more authority as a reflection of current principles.

(b) *The elements of financial reporting*

The *Conceptual Framework* defines five elements – assets, liabilities, equity, income and expenses. (These definitions are taken from the 2015 Exposure Draft.)

- 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.)
- A **liability** a present obligation of the entity to transfer an economic resource as a result of past events.
- **Equity** is the residual interest in the assets of the enterprise after deducting all its liabilities.
- **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.
- **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 definitions are fundamental to the preparation of financial statements. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of an entity's financial position are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit or loss are income and expenses. The statement of changes in equity usually reflects statement of comprehensive income elements and changes in statement of financial position elements.

It is essential that only items which meet these definitions are included in financial statements, and that all such items are included so that the financial statements give a true and fair view of the financial state of affairs of an entity. Without the definitions it would be impossible to specify when the elements should be recognised, and then how they should be measured.

Examples to illustrate how without the definitions financial statements could include or exclude misleading or important information for users respectively include off-balance sheet financing, excessive provisions, and intangible assets.

The qualitative characteristics

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The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. This objective by itself leaves a great deal to judgement and provides little guidance on how to exercise that judgement. The qualitative characteristics describe the first step in making the judgements needed to apply that objective as they identify what makes financial information useful to the users in their decision-making.

The two qualitative characteristics of relevance and faithful representation are defined as fundamental, as without these financial information is not useful. Four further qualitative characteristics are defined as enhancing, meaning that the information is more useful if it is comparable, verifiable, timely or understandable. These characteristics do not have to be present for information to be useful, provided it is still relevant and faithfully represented.

Relevance
Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources. Financial information can make a difference to decisions if it has:

- Predictive value – It can be used to predict future outcomes.
- Confirmatory value – It provides feedback about previous evaluations (it confirms whether past predictions were reasonable).

Information's relevance is affected by its nature and materiality (in other words its 'importance'). Information may become less relevant if there is undue delay in its reporting.

Possible examples – the use of fair (market) value is said to be more relevant for decision-making than historic cost – e.g. PPE revaluation model, use of fair value for investment properties, use of recoverable amount in impairment.
Required disclosures give relevant information – e.g. the separation of results from discontinued operations in the statement of profit or loss, and the separation of assets held for sale assist with forecasts.

Faithful representation
If information is to be useful, it must represent faithfully the transactions and other events it purports to represent. A faithful representation will be:

- **Complete** – All information necessary for a user to understand the transactions or events being depicted is included.
  Possible examples – Disclosures for PPE provide break-down of one value into the different values for each class of asset and their cost and accumulated depreciation; goods sold under certain types of warranty – the revenue is included and a related provision for any anticipated repair/ replacement costs.

- **Neutral** – unbiased
  Possible examples – Provisions should be valued using a ‘best estimate’, not one that is biased towards over-providing; depreciation should be based on the expected useful life. The 2015 ED has reintroduced prudence in its discussion of

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neutrality and states that neutrality is supported by the exercise of prudence, where prudence is the exercise of caution when making judgements under conditions of uncertainty. In various financial reporting standards, neutrality often appears to be superseded by prudence, e.g. inventory valued at the lower of cost and NRV, account for a provision when a liability is probable but disclosure note for a probable contingent asset, treatment of impairment loss v. gain.

- **Free from error** – Free from error in the context of faithful representation does not mean the information is perfectly accurate in all respects. Instead it means there are no errors or omissions in the description of it and the process used to produce the reported information has been selected and applied with no errors in the process.
  Possible examples – this is more to do with processes, such as financial reporting systems of companies and the audit, although neither of these can guarantee this. The concept of materiality is key here – and companies and their auditors should work with acceptable levels of materiality.

Comparability
Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information should be produced so that valid comparisons can be made with information from previous periods and with information produced by other entities (for example, the financial statements of similar companies operating in the same line of business). Comparability should not be confused with consistency. Applying consistency (using the same methods for the same items) is a means of achieving comparability (comparability is the goal).

Possible examples – IAS 1 formats and disclosures; no change in accounting policies from one year to the next without good reason (and then full disclosure of the reason and effect); depreciation changes in estimates permitted but only with good reason and full disclosure.

Verifiability
Verifiability helps to assure users that information is a faithful representation of the transactions or events it purports to represent. If information is verifiable it essentially means that it can be proven, for example it may be able to be checked it is true by examination, inspection or comparison. The *Conceptual Framework* states that "verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation".

Possible examples – The financial reporting systems of companies and the audit should ensure the verifiability of financial information. Disclosures of areas where significant judgments and estimates have been used are required to be disclosed (IAS 1).

Timeliness
Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. As a general rule older information is less

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useful than recent information. However, note that some information may still be timely for a long time after the end of a reporting period. This is true of information for users of financial information who need to identify and assess trends.

Possible examples – This is more to do with the financial reporting system in general – in the UK there are time limits by which public and private companies have to file their financial statements.

Understandability
Information is understandable if it is classified, characterised and presented clearly and concisely. When considering whether information is understandable it should be borne in mind that financial reports are prepared for users who have a reasonable knowledge of business and economic activities.

Possible examples – Disclosures are paramount here and every IFRS sets out the disclosure requirements for the particular item and transaction dealt with. Accounting policies are required by IAS 8 to be disclosed so users understand the accounting methods of recognition and measurement used. Details of where judgements and estimates have been used should be disclosed so that users can form an opinion on the reliability or otherwise of financial information (IAS 1). Offsetting is not permitted (IAS 1).

Question 8

Using the definitions of assets and liabilities and the recognition criteria set out in the 2015 Exposure Draft to the IASB's *Conceptual Framework*:

Definition of an asset:
- A present economic resource
- Controlled by the business
- As a result of past events

Definition of a liability:
- A present obligation of the business
- To transfer an economic resource
- As a result of past events

Assets and liabilities are recognised if their inclusion provides information that is:
(i) relevant, and
(ii) faithfully representative

Recognition may not be met if:
- There is uncertainty over existence
- Future flows of economic benefits are unlikely
- Measurement is uncertain

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(1) Receivables meet the definition of an asset. Questions arise over whether Pardew's debt should be recognised as its inclusion would not be considered faithfully representative of the fact that Pardew is in administration. There is clear uncertainty over whether there will be future inflows of economic benefits from this receivable, and what the value of any future inflows will be. If it is considered unlikely that it will be received, the receivable should not be recognised, and an allowance for the receivable should be made and set off against receivables.

The Greek customers' debts have been settled through the factoring arrangement, but Carduus has to consider whether any defaults by customers will mean a liability, the definition of which is met, should be recognised. There is uncertainty over whether there will be any outflows (Carduus repaying the factoring company), and the company will have to form a judgement on this based on details of the customers, how long the debts are overdue, what the history of payments by the customers is, etc. If it is considered likely that some customers will default, then Carduus should recognise a liability and should be able to provide an estimate of the amount.

(2) The definitions of both an asset and a liability are relevant.

The delivery vehicles are considered assets of Carduus plc because they are an economic resource (the economic benefits are the revenues generated from the use of the vehicles) controlled by the company and the lease contract is a past event. Information about all resources of a company are relevant to users, and their inclusion in the financial statements contributes to the financial statements being faithfully representative.

A question arises over the initial measurement of the vehicles – should this be their purchase price or what will ultimately be paid for them? How should the interest element which is included in the payments be accounted for?

The lease contract has also given rise to a liability as a legal obligation for the lease payments exists. The recognition of this will ensure the financial statements are relevant and complete. The initial measurement of the liability should also be considered carefully as there is an interest element included in the payments, and the payments will be spread over some years, so the time-value of money should be considered.

(Note – IAS 17 *Leases* which has been replaced by IFRS 16 *Leases* outlines the accounting for leases and deals with the measurement issues.)

(3) The question here is whether there is an asset as defined by the *Conceptual Framework*:

- The resource is the enhancement of the staff skills and expertise.
- There is a past event – the training.
- However Carduus cannot be considered to control the resource – as with any staff skills and expertise, there is no guarantee that these will be used for the benefit of the company, and staff can decide to leave.

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Given the definition criteria are not fully met, there is no asset to be recognised.

(4) Consider whether this meets the definition of a liability:

- Although a claim has been made for the supply of faulty goods, a question remains as to whether this means there is a present obligation. The claim may be entirely erroneous. If there has been a supply of faulty goods and Carduus has terms in its sale contracts for rectification or reimbursement, there may a present obligation.
- The sale of goods is the past event.
- Will there be a transfer of economic resources? This may depend on the terms and conditions of any sale contract.

If the definition criteria are met, the next question is whether the liability should be recognised. Information about material compensation claims would be considered relevant and, without inclusion, the financial statements could not be said to be faithfully representative. However questions arise as to how likely any compensation payments are, and the uncertainties that exist over the reliability of measurement – at the moment only a possible range exists. Carduus will need to take legal advice.

(5) The hostile take-over, although putting pressure on management, is irrelevant, as financial accounting information needs to be neutral.

Consider the definition criteria for an asset:

- Brands are often considered very significant resources for companies.
- A brand is an item that is controlled
- There is a past event for the purchased brand – the date of the purchase of the other company. However for the company's other brands, which may include internally developed brands, a past event becomes difficult to determine unless the trade name or mark has been patented or registered.

The next question is whether the brands can be recognised?
Information about brands would be considered relevant and, without inclusion, the financial statements could not be said to be faithfully representative. Future inflows of economic benefits (future sales) are likely to be enhanced through brand recognition. For the brand acquired through the acquisition of the other company, the brand would have an agreed valuation. However for Carduus' other internal brands external valuations may be possible, but there is a question of their reliability. It would also be difficult to measure these brands by any other means as it would be impossible to separate out the costs of developing a brand from other business costs.

This would mean that the purchased brand could be recognised, but the internal brands could not.

(6) This is a question about whether internal goodwill is a recognisable asset.

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Consider the definition criteria of an asset:

- The sorts of intangible items detailed could be considered as economic resources of Carduus.
- However there is a question as to whether the company controls them. Customer loyalty and employee expertise can very easily go elsewhere.
- The past event criterion is difficult to determine, e.g. when does a customer become loyal?

Although it may be considered useful to include information about internal goodwill in financial statements, the recognition criteria for an asset are not met, and it would be impossible to produce a reliable measurement of items such as a workforce's expertise and customer loyalty. So internal goodwill cannot be recognised.

Question 9

In its 2015 Exposure Draft of the *Conceptual Framework*, the IASB proposes a more extensive measurement section that:
(a) describes the different measurement methods that might be used, and
(b) discusses the factors that the IASB should consider when selecting an appropriate measurement method to apply in any given situation.

There are many different ways in which an asset or liability can be measured. The IASB includes two bases which should underpin all measurement methods used in financial reporting standards. The first is historical cost which relies partly or wholly on information derived from a past transaction. The other is current value which reflects current circumstances and make no use of historical information. However neither basis can be considered to provide more useful information to users than the other in all situations.

Historical cost
Historical cost may provide more relevant information to those users who wish to focus on stewardship, which is now more prominent as an objective of financial reporting in the 2015 ED. Historical cost is the price paid for a resource which the directors are entrusted to use, and so returns measured against historical cost could be considered a better measure of their stewardship.

Historical cost does not recognise unrealised gains on assets, and so it is more conservative than any of the current value bases, and this may appeal to some users. Lenders and other creditors may consider that their interests are better protected if net assets are measured conservatively, as this reduces the extent to which the company's assets can be paid out as dividends. They may regard the distribution of unrealised gains, which historical cost avoids, as especially risky. Shareholders also gain to the extent that it is therefore easier for the business to raise loans and other credit.

If the business is taxed on its reported profit, then historical cost has the advantage that it avoids the problems of the company having to find cash to pay tax on unrealised gains. Where managers are rewarded on the basis of reported profit, investors may also prefer it

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to be measured with caution. If profits subsequently prove to be overstated, investors are unlikely to be able to get the company's money back from its managers.

There are other important characteristics of historical cost information that may appeal to some users. It is the most objective measure, and can be said to be more faithfully representative since historical cost is unbiased, complete and less prone to error. It therefore (usually) provides users with reliable and transparent information. Its fundamental approach of comparing actual costs incurred with income realised matches a fundamental objective of business. For most businesses, it is also more likely than other measurement bases to match the information that management uses.

Critics of historical cost argue that its measurements are inherently irrelevant to any contemporary decision because they are out-of-date and provide no guide to an entity's current financial position. One result of its use is that internally generated intangibles, which are increasingly critical to businesses, are typically ignored, as well as financial instruments that have no cost. They also argue that failing to take into account unrealised gains may significantly understate both net assets and income or allocate income to particular years on grounds (realisation) that are irrelevant to its measurement.

It may seem easy to determine the historical cost of an asset or liability, and in simple situations it is easy to determine initial cost – the cash paid or received. But if one considers, for example, a deferred payment, for which the time value of money needs to be considered, or a payment with consideration other than cash, things become more complex. In addition, determining historical cost after initial recognition is not straightforward. Historical cost relies on rules and conventions to specify what is included and how it should subsequently be adjusted (for example, rules and conventions about depreciation and impairment). The need for these rules and conventions causes complexity and makes it challenging for investors to interpret the output.

Current values

Current values encompass a variety of alternative valuation methodologies. The IASB includes fair value, i.e. prices quoted in a market, or values based on entity-specific factors (value in use for assets and fulfilment value for liabilities) as alternative current value bases. Current values can be 'customised' by, for example, using a combination of market and entity-specific estimates. Of these alternative methods, only current market prices can be considered unambiguous (although even for fair value there are questions, for example, about which market price is most relevant). Any other current value is likely to require specific rules or conventions to make it operational and to avoid inconsistent application – a drawback shared with historical cost.

Current values are considered more relevant for the primary decision-usefulness objective of financial reporting. Firstly they are up-to-date. Secondly, information given about assets and liabilities, when they are measured at fair value, has predictive value, because fair value reflects expectations about the amount, timing and uncertainty of the cash flows (reflecting market participants' expectations). Thirdly, fair values may also have confirmatory value by providing feedback about previous estimates. Value in use or fulfilment value are based on a model using future cash flow estimates, which is a key information requirement for users.

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Where current values are based on market values, investors and lenders will be able to see what could be realised on the disposal of the business's separable assets. This is also a measure of the opportunity cost of holding the assets. This information may be particularly relevant where assets such as investments and properties, for example, could be disposed of separately without affecting the underlying business.

Market values do not necessarily provide the most relevant information for all assets though. This will be the case when the business activities conducted by the company do not involve selling the asset or transferring the liability; for example, if assets are held solely for use or to collect contractual cash flows, or if liabilities are to be fulfilled by the reporting entity itself. The inclusion of unrealised gains or losses would not be considered to be faithfully representative in these cases.

Where fair values are taken from active markets, they are verifiable, objective, simple to understand and comparable. However, a key question is how fair values should be determined where there is no active market. Financial models have to be employed which use various estimates, all of which increase subjectivity and reduce comparability between businesses, particularly where the inputs used in the models are less observable. The use of complex models also reduces understandability.

Approach by the IASB

Although there are many who would advocate a single measurement approach, often for simplicity's sake, it can be seen from the above arguments that there are advantages and drawbacks to different measurement bases. The use of just one basis may enhance information provided for certain assets and liabilities and way that profit is reported, but will not be relevant or faithfully representative for other assets and liabilities. The IASB listens to parties who have an interest in financial reporting, and responds to them, and the vast majority of those who comment on the work of the IASB favour a mixed measurement approach. This is also consistent with the approach most investors take in analysing financial statements. So the IASB's Exposure Draft to the *Conceptual Framework* outlines this mixed approach, whereby the most relevant measurement method is selected for each category of assets and liabilities.

This does raise further questions – which is the most relevant and faithfully representative measure (the financial reporting standard for a particular item usually addresses this, but, in some cases, still leaves some choice); should the activities of a particular business and how it uses to the asset or liability to generate wealth affect the measurement basis used (which will lead to lack of inter-company comparisons); could the measurement for performance differ from that used for financial position? These issues, and others, may need addressing before the final *Conceptual Framework* is published.

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Question 10

Fair value of asset

	North American market	*European market*	*African market*
Year to 31 March 20X4			
Volume of market – units	4m	2m	1m
	£	£	£
Price	19	16	22
Costs of entering the market	(2)	(2)	n/a*
Potential fair value	17	14	22
Transaction costs	(1)	(2)	(2)
Net profit	16	12	20

Notes:

(i) Because Haddon currently buys and sells the asset in the African market, the costs of entering that market are not incurred and therefore not relevant.

(ii) Fair value is not adjusted for transaction costs. Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

(iii) The North American market is the principal market for the asset because it is the market with the greatest volume and level of activity for the asset. If information about the North American market is available and Haddon can access the market, then Haddon should base its fair value on this market. Based on the North American market, the fair value of the asset would be £17, measured as the price that would be received in that market (£19) less costs of entering the market (£2) and ignoring transaction costs.

(iv) If information about the North American market is not available, or if Haddon cannot access the market, Haddon must measure the fair value of the asset using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and usually also costs of entry, that is, the net amount that would be received in the respective markets. The most advantageous market here is therefore the African market. As explained above, costs of entry are not relevant here, and so, based on this market, the fair value would be £22.

It is assumed that market participants are independent of each other and knowledgeable, and able and willing to enter into transactions.

Fair value of decommissioning liability

Because this is a business combination, Haddon must measure the liability at fair value in accordance with IFRS 13, rather than using the best estimate measurement required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* In most cases there will

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be no observable market to provide pricing information. If this is the case here, Haddon will use the expected present value technique to measure the fair value of the decommissioning liability. If Haddon were contractually committed to transfer its decommissioning liability to a market participant, it would conclude that a market participant would use the inputs as follows, arriving at a fair value of £3,215,000.

Input	£000
Labour and material cost	2,000
Overhead: 30% x 2,000	600
Third party mark-up – industry average: 2,600 x 20%	520
	3,120
Inflation adjusted total (5% compounded over three years): 3,120 x 1.05^3	3,612
Risk adjustment – uncertainty relating to cash flows: 3,612 x 6%	217
	3,829
Discount at Haddon's internal rate of interest adjusted for risk of 6%: 3,829 / 1.06^3	3,215

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