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IFRS Foundation: Training Material for the *IFRS® for SMEs*

Module 2 – Concepts and Pervasive Principles

IFRS™

IFRS Foundation: Training Material for the IFRS® for SMEs

including the full text of
Section 2 *Concepts and Pervasive Principles*
of the International Financial Reporting Standard (IFRS)
for Small and Medium-sized Entities (SMEs)
issued by the International Accounting Standards Board on 9 July 2009

with extensive explanations, self-assessment questions and case studies

IFRS Foundation®
30 Cannon Street
London EC4M 6XH
United Kingdom

Telephone: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
Email: info@ifrs.org

Publications Telephone: +44 (0)20 7332 2730
Publications Fax: +44 (0)20 7332 2749
Publications Email: publications@ifrs.org
Web: www.ifrs.org

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IFRS Foundation®
30 Cannon Street | London EC4M 6XH | United Kingdom
Telephone: +44 (0)20 7246 6410 | Fax: +44 (0)20 7246 6411
Email: info@ifrs.org Web: ww.ifrs.org

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Module 2 – Concepts and Pervasive Principles

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB).
The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in *the International Financial Reporting Standard (IFRS) for SMEs*, which was issued by the IASB in July 2009.

INTRODUCTION

This module focuses on the agreed concepts that underlie financial reporting in accordance with the *IFRS for SMEs*. The concepts in Section 2 are taken from the IASB's *Framework for the Preparation and Presentation of Financial Statements* which, in 2010, was renamed the *Conceptual Framework for Financial Reporting* when parts of it were updated. The concepts in the *Conceptual Framework* are derived from the objective of financial reporting—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 recourses to the entity. Many of the notes presented in this module are derived from the Basis for Conclusions on the *Conceptual Framework*.

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users (eg existing and potential investors, lenders and other creditors) who are not in a position to demand reports tailored to meet their particular information needs.

The IASB uses the concepts to set financial reporting requirements. This enhances the consistency across IFRS requirements and provides a benchmark for making judgements. Preparers of financial statements also use the concepts in applying the *IFRS for SMEs*. When the *IFRS for SMEs* does not cover a topic they are dealing with, preparers *must* use the concepts to guide them in deciding how to deal with that topic. The concepts may assist auditors in forming an opinion on whether financial statements comply with the *IFRS for SMEs*.

The main concepts in Section 2 that flow from the objective of general purpose financial statements are the qualitative characteristics of financial information and the definitions of the elements. Section 2 also provides pervasive principles for the recognition and measurement of those elements.

This module introduces the learner to the subject, guides the learner through the official text, develops the learner's understanding of the requirements through the use of examples and indicates significant judgements that are required in applying Section 2. Furthermore, the module includes questions designed to test the learner's knowledge of the requirements as well as case studies to develop the learner's ability to apply the qualitative characteristics of the financial information, as well as the recognition and measurement of the elements of financial statements, in accordance with the *IFRS for SMEs*.

Learning objectives

Upon successful completion of this module the learner should understand the objective of general purpose financial statements and the concepts and pervasive principles that flow from

that objective. Understanding the concepts that the IASB uses to set requirements provides a cohesive understanding of the *IFRS for SMEs* and better prepares you for effective lifelong learning, particularly because, every three years or so, some of the requirements in the *IFRS for SMEs* are likely to change.

You should also know when and how to apply the concepts and pervasive principles when using your judgement in developing and applying accounting policies in accordance with the *IFRS for SMEs*. Furthermore, through the completion of case studies that simulate aspects of the real-world application of that knowledge, you should have enhanced your ability to deal with topics that do not form part of the *IFRS for SMEs*. In particular you should, in the context of the *IFRS for SMEs*, be able:

- to demonstrate an understanding of the objective of general purpose financial statements and the concepts and pervasive principles that flow from that objective.
- to use your judgement in developing and applying an accounting policy that results in information that is both relevant to the economic decision-making needs of users and is reliable[(1)].

IFRS for SMEs

A distinction needs to be drawn between the *IFRS for SMEs* (mandatory requirements) and the other material that is published with it.

The mandatory requirements are accompanied by other (non-mandatory) material, as follows:

- the Basis for Conclusions, which summarises the IASB's main considerations in reaching the conclusions in the *IFRS for SMEs*.
- the dissenting opinion of an IASB member who did not agree with the issue of the *IFRS for SMEs*.
- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority.
- implementation guidance including illustrative financial statements and a disclosure checklist.

In the *IFRS for SMEs* the Glossary is part of the mandatory requirements.

In the *IFRS for SMEs* there are appendices in Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue.* Those appendices are non-mandatory guidance.

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(1) In September 2010 the IASB issued the *Conceptual Framework for Financial Reporting*. In that *Conceptual Framework* the IASB replaced the term 'reliability' with 'faithful representation'. Faithful representation in the *Conceptual Framework* differs from that in the Framework (1989) in two significant ways. First, it uses the term *faithful representation* instead of the term *reliability* because the term reliability was widely misunderstood (in particular, many respondents' descriptions of reliability more closely resembled the IASB's notion of verifiability). Second, substance over form, prudence (conservatism) and verifiability, which were aspects of reliability in the *Framework* (1989), are not considered aspects of faithful representation. Substance over form and prudence were removed for the reasons described in paragraphs BC3.26–BC3.29. Verifiability is now described as an enhancing qualitative characteristic rather than as part of this fundamental qualitative characteristic.

Module 2 – Concepts and Pervasive Principles

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, financial performance and cash flows that is useful for economic decision-making by a broad range of users (eg existing and potential investors, lenders and other creditors) who are not in a position to demand reports tailored to meet their particular information needs.

The main concepts in Section 2 that flow from the objective of general purpose financial statements prepared using the accrual basis of accounting are the qualitative characteristics of financial information and the definitions of the elements. Section 2 also provides some basic principles for the recognition, measurement and presentation of the elements of financial statements.

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The primary qualitative characteristics are relevance and reliability. To inform a user's decision, information must be both relevant to the economic decision-making needs of the users and reliable (including a neutral and faithful representation of the entity's financial position and financial performance). The usefulness of that information is enhanced if it is also, for example, timely, complete and comparable.

When the *IFRS for SMEs* does not specifically address a transaction, other event or condition, an entity's management uses judgement in developing and applying an accounting policy that results in information that is both relevant to the economic decision-making needs of users and reliable. If, in making these judgements, management cannot by analogy use the requirements and guidance in the *IFRS for SMEs* dealing with similar and related issues, then it must apply the definitions of the elements, the recognition criteria and measurement concepts and pervasive principles in Section 2 (see paragraphs 10.4 and 10.5). Consequently, the concepts and pervasive principles in Section 2 are fundamental to understanding the *IFRS for SMEs* and inform the judgements that are necessary to apply it.

The elements of financial statements are assets, liabilities, equity, income and expenses. Assets and liabilities are the cornerstone elements because equity, income and expenses are defined with reference to assets and liabilities. The *IFRS for SMEs* requires the accrual basis of accounting—an element (eg asset and liability) is recognised when it is probable that any future economic benefit associated with it will flow to or from the entity and the element has a cost or value that can be measured reliably. The meaning of probability is determined at the requirement level—in many circumstances, when applying the *IFRS for SMEs* 'probable' means more likely than not (ie a greater than 50 per cent probability). However, in other circumstances (eg when accounting for derivatives and when allocating the cost of a business combination) probability means greater than a zero per cent probability.

Many different measurements are specified in the *IFRS for SMEs*. Two common measurement bases are historical cost and fair value. Historical cost is the amount of cash or cash equivalent paid or the fair value of the consideration given to acquire the asset at the time of its acquisition. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Measurement is determined at the requirement level and different measurements can be specified for a particular item at initial recognition and subsequently. Furthermore, the measurement required might vary depending upon the purpose to which an asset is put (eg measurement of land after recognition is different from that of inventory, property, plant and equipment or investment property). The required measurement might also depend upon the

ability of management to determine its fair value (eg investment property is measured at fair value unless its fair value cannot be measured reliably on an ongoing basis without undue cost or effort, in which case it is measured using a cost-depreciation-impairment model).

Regarding presentation, Section 2 establishes the principle that in its financial statements an entity cannot offset assets and liabilities or offset income and expenses, unless required or permitted to do so by the *IFRS for SMEs*.

Module 2 – Concepts and Pervasive Principles

REQUIREMENTS AND EXAMPLES

The contents of Section 2 *Concepts and Pervasive Principles* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the Glossary are also part of the requirements. They are in **bold type** the first time they appear in the text of Section 2. The notes and examples inserted by the IFRS Foundation education staff are not shaded. Other annotations inserted by the IFRS Foundation staff are presented within square brackets in ***bold italics***. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

Scope of this section

2.1 This section describes the **objective of financial statements** of small and medium-sized entities (SMEs) and the qualities that make the information in the financial statements of SMEs useful. It also sets out the concepts and basic principles underlying the financial statements of SMEs.

Notes[2]

IFRSs are based on the IASB's *Conceptual Framework*, which addresses the concepts underlying the information presented in general purpose financial statements. The objective of the *Conceptual Framework* is to facilitate the consistent and logical formulation of IFRSs. It also provides a basis for the use of judgement in resolving accounting issues (paragraph P6 of the preface to the *IFRS for SMEs*).

To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions. The *Conceptual Framework* establishes the concepts that underlie those estimates, judgements and models. The concepts are the goal towards which the Board and preparers of financial reports strive.

Section 2 of the *IFRS for SMEs* was developed from the concepts in the *Conceptual Framework*. Because other aspects of Section 2 flow logically from the objective of general purpose financial statements of small and medium-sized entities, a good understanding of the objective is fundamental to understanding the standard.

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[2] In September 2010, after the *IFRS for SMEs* was issued, the IASB issued the *Conceptual Framework for Financial Reporting*. That *Conceptual Framework* replaced the Framework (1989) on which the requirements in Section 2 are based. The *Conceptual Framework* clarifies the objective of general purpose financial reporting and the qualitative characteristics of useful financial information. The *Conceptual Framework* also includes unaltered (except for renumbering the paragraphs) the text of the other requirements of the Framework. Many of the notes in Module 2 are taken from from the *Conceptual Framework* and the Basis for Conclusions on Chapters 1 and 2 of the *Conceptual Framework*.

Module 2 – Concepts and Pervasive Principles

Objective of financial statements of small and medium-sized entities

2.2 The objective of financial statements of a small or medium-sized entity is to provide information about the **financial position**, **performance** and **cash flows** of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.

Notes

General purpose financial statements are not designed to show the equity value of a reporting entity; but they provide information to help users to estimate the equity value of the reporting entity.

General purpose financial reports also do not and cannot provide all of the information that users (eg existing and potential investors, lenders and other creditors) need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.

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. For example, in making decisions about providing resources to the entity, existing and potential investors, lenders and other creditors need financial information about the reporting entity that is useful in deciding whether to buy, sell or hold equity and debt instruments, and whether to provide or require settlement of loans and other forms of credit. Regulators and members of the public other than investors, lenders and other creditors may find information in general purpose financial reports useful. Section 2 does not explicitly identify a group of primary users. Individual users have different, and possibly conflicting, information needs and desires. Focusing on common information needs (using investors' needs as representative of the needs of a wide range of users) does not prevent the reporting entity from including additional information that is most useful to a particular subset of primary users.

In establishing standards for the form and content of general purpose financial statements, the needs of users of financial statements are paramount. Users of financial statements of SMEs may have less interest in some information in general purpose financial statements prepared in accordance with full IFRSs than do users of financial statements of entities whose securities are registered for trading in public securities markets or that otherwise have public accountability. For example, users of financial statements of SMEs may have greater interest in short-term cash flows, liquidity, strength of its statement of financial position and interest coverage, and in the historical trends of profit or loss and interest coverage, than they do in information that is intended to assist in making forecasts of an entity's long-term cash flows, profit or loss, and equity value. However, users of financial statements of SMEs may need some information that is not ordinarily presented in the financial statements of listed entities. For example, as an alternative to the public capital markets, SMEs often obtain capital from shareholders, directors and suppliers, and

shareholders and directors often pledge personal assets so that the SMEs can obtain bank financing.

External users of financial reporting have similar objectives, irrespective of the type of entities in which they invest. Consequently, the objective of general purpose financial reports is the same for all entities. However, cost constraints and differences in activities among entities may sometimes lead the IASB to permit or require differences in reporting for different types of entities. For example, in developing the *IFRS for SMEs* by making simplifications to full IFRSs, the IASB acknowledges that differences in the types and needs of users of SMEs' financial statements, as well as limitations in, and the cost of, the accounting expertise available to SMEs, suggested that a separate standard for SMEs is appropriate.

2.3 Financial statements also show the results of the stewardship of management—the accountability of management for the resources entrusted to it.

Notes

The objective of financial reporting acknowledges that users make resource allocation decisions as well as decisions as to whether management has made efficient and effective use of the resources provided. Information designed for resource allocation decisions is also useful for assessing management's performance.

Information about stewardship is also important for resource providers, who have the ability to vote on, or otherwise influence, management's actions. As well as making decisions on resource allocation, investors, lenders and other creditors make other decisions that are aided by financial reporting information. For example, shareholders who vote on whether to retain directors or replace them, and on how members of management should be remunerated for their services, need information on which to base their decisions. Shareholders' decision-making processes may include evaluating how management of the entity performed against management in competing entities in similar circumstances.

Qualitative characteristics of information in financial statements

Notes

Alternatives are available for all aspects of financial reporting, including recognition, derecognition, measurement, classification, presentation and disclosure. When developing financial reporting standards, the IASB chooses the alternative that goes furthest towards achieving the objective of financial reporting. Providers of financial information also choose among the alternatives if there are no applicable standards available, or if application of a particular standard requires judgements or options, to achieve the objective of financial reporting.

The qualitative characteristics of useful financial information identify the characteristics of information that are likely to be most useful to existing and

potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report. Consequently, as long as the benefits exceed the costs, maximising the qualitative characteristics of financial information guides the judgements needed to apply the objective of financial reporting.

The most critical qualitative characteristics are relevance and reliability (faithful representation). Other qualitative characteristics are less critical but still highly desirable. Consequently, those less critical qualitative characteristics (eg comparability, verifiability, timeliness and understandability) are sometimes referred to as 'enhancing qualitative characteristics'.

Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximise another. For example, a temporary reduction in comparability as a result of prospectively applying an amendment to the *IFRS for SMEs* may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for non-comparability.

Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions about which they are more confident. If financial information is to be useful, it must be relevant (ie it is capable of making a difference in the decisions made by users because it has predictive value, confirmatory value or both and faithfully represents what it purports to represent).

Neither a faithful representation of an irrelevant phenomenon, nor an unfaithful representation of a relevant phenomenon, helps users to make good decisions. Consequently, relevance and reliability are fundamental characteristics. Financial information without the fundamental qualitative characteristics of relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely or understandable. However, financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics.

Understandability

2.4 The information provided in financial statements should be presented in a way that makes it comprehensible by users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, the need for understandability does not allow relevant information to be omitted on the grounds that it may be too difficult for some users to understand.

Notes

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

Information that is difficult to understand should be presented and explained as clearly as possible.

Users are responsible for *actually* studying reported financial information with reasonable diligence rather than only being willing to do so. In addition, users may need to seek the aid of advisers to understand economic phenomena that are particularly complex.

Examples—understandability

Ex 1 **An entity chooses not to account for deferred tax because its management believes that the users of its financial statements would not understand that financial information.**

The entity cannot claim compliance with the *IFRS for SMEs* if it chooses not to account for deferred tax in accordance with Section 29 *Income Tax* on the grounds that management believes that the users of its financial statements would not understand that financial information.

Ex 2 **A plan provides a monthly pension of 0.2 per cent of final salary for each year of service. The pension is payable from the age of 65. The entity chooses not to account for the defined benefit plan because its management believes that the users of its financial statements would not understand that financial information.**

The entity cannot claim compliance with the *IFRS for SMEs* if it chooses not to account for those pensions in accordance with Section 28 *Employee Benefits* on the grounds that management believes that the users of its financial statements would not understand that financial information.

Relevance

2.5 The information provided in financial statements must be relevant to the decision-making needs of users. Information has the quality of **relevance** when it is capable of influencing the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

Notes

It is self-evident that financial information is useful for making a decision only if it is capable of making a difference in that decision. Relevance is the term used to describe that capability. It is a fundamental qualitative characteristic of useful financial information.

Many decisions by investors, lenders and other creditors are based on implicit or explicit predictions about the amount and timing of the return on an equity investment, loan or other credit instrument. Consequently, information is capable of making a difference in one of those decisions only if it will help users to make new predictions (predictive value), or help users to confirm or correct prior predictions (confirmatory value), or both. Predictive value in this context is not the same as predictability and persistence as used in statistics. Information has predictive value if it can be used in making predictions about the eventual outcomes of past or current events. In contrast, statisticians use predictability to refer to the accuracy with which

it is possible to foretell the next number in a series and persistence to refer to the tendency of a series of numbers to continue to change as it has changed in the past.

Predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value. For example, revenue information for the current year, which can be used as the basis for predicting revenues in future years, can also be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

Materiality

2.6 Information is **material**—and therefore has relevance—if its omission or misstatement could influence the economic decisions of users made on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. However, it is inappropriate to make, or leave uncorrected, immaterial departures from the *IFRS for SMEs* to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

Notes

Materiality is an aspect of relevance, because immaterial information does not affect a user's decision. Financial statement users are assumed to have a reasonable knowledge of business, economic activities and accounting and a willingness to study financial information with reasonable diligence (see paragraph 2.4). Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of such users made on the basis of the financial statements.

Because materiality is an entity-specific consideration, the IASB does not consider materiality when developing standards. Materiality is 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. Consequently, the IASB cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

The definition of material implies that an entity need not provide a specific disclosure required by the *IFRS for SMEs* if the information is not material. Moreover, an entity need not apply its accounting policies when the effect of not applying them is immaterial (see paragraph 10.3).

Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements. If an item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.

Examples—immaterial items

Ex 3 **In 20X9, before the entity's 20X8 financial statements were approved for issue, the entity discovered an error in the calculation of depreciation expense for the year ended 31 December 20X8. Management ignored the error (ie the entity's reported profit before tax for the year ended 31 December 20X8 of CU600,000[(3)] was understated by CU150).**

The error is probably not material—it is highly unlikely that an error of this magnitude could influence the economic decisions of users made on the basis of the financial statements.

Ex 4 **The facts are the same as in example 3. However, in this example, the error was discovered in 20X9, after the entity's 20X8 financial statements were approved for issue.**

The prior period error is probably not material—it is highly unlikely that a prior period error of this magnitude could influence the economic decisions of users made on the basis of the financial statements.

Examples—material items

Ex 5 **The facts are the same as in example 3. However, in this example, if the error had been corrected the entity would have breached a borrowing covenant on a significant long-term liability.**

The error is material—it could influence the economic decisions of users made on the basis of the financial statements.

Ex 6 **In 20X9, before the entity's 20X8 financial statements were approved for issue, the entity discovered a systemic error in the calculation of its defined benefit obligation in respect of the employees' pension scheme. Further investigation revealed that the calculation had been incorrectly performed since the defined benefit plan was started in 20X0. The cumulative effect of the error on the retained earnings of the entity at the beginning of 20X8 is an overstatement of CU600,000. The entity reported total equity of CU950,000 at 31 December 20X7.**

The error is material—it could influence the economic decisions of users made on the basis of the financial statements.

Ex 7 **In 20X9, before the entity's 20X8 financial statements were approved for issue, a class action lawsuit was filed against the entity. The lawsuit seeks compensation for a community experiencing health problems allegedly caused by pollution from the entity's plant. Legal counsel advised management that there is a 30 per cent chance that the action will be successful. If successful, the court is likely to award the community compensation of between CU1,000,000 and CU2,000,000.**

In its financial statements for the year ended 31 December 20X8, the entity neither recognised a liability for the lawsuit nor disclosed any information about it.

[(3)] In this example, and in all other examples in this module, monetary amounts are denominated in 'currency units (CU)'.

For the year ended 31 December 20X8, the entity reported profit for the year of CU600,000.

The error (omission) is material—it could influence the economic decisions of users made on the basis of the financial statements.

Notes:

If, after taking account of all of the available evidence, it is probable that the entity will successfully defend the court case, the entity has a possible obligation and consequently a contingent liability. In accordance with paragraph 21.12 the entity would be required to disclose specified information about the contingent liability.

If, after taking account of all of the available evidence, it is probable that the entity will lose the court case, the entity is deemed to have a present obligation, and consequently a liability of uncertain timing or amount—ie a provision. In accordance with paragraph

21.4 and 21.7 the entity would be required to recognise the liability measured at the best estimate of the amount that an entity would rationally pay to settle the obligation at the end of the reporting period.

Reliability

2.7 The information provided in financial statements must be **reliable**. Information is reliable when it is free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent. Financial statements are not free from bias (ie not neutral) if, by the selection or presentation of information, they are intended to influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Notes

Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics: it would be *complete*, *neutral* and *free from error*. Of course, perfection is seldom, if ever, achievable. The IASB's objective is to maximise those qualities as far as possible.

Faithful representation does not mean accurate in all respects. Free from error means that there are no errors or omissions in the description of the phenomenon, and that the process used to produce the reported information has been selected and applied with no errors in that process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate. In other words, reliability does not mean precision.

A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

Substance over form

2.8 Transactions and other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form. This enhances the reliability of financial statements.

Note

Representation on the basis of a legal form that differs from the economic substance of the underlying economic phenomenon could result in a representation that is not faithful.

Examples—substance over form

Ex 8 **A luxury yacht manufacturer sells a yacht to a bank for CU1,000,000 and simultaneously enters into an agreement to repurchase the yacht from the bank for CU1,080,000 one year later.**

On the date of entering into the transaction, the fair value of the yacht was CU2,000,000 and the manufacturer's incremental borrowing rate approximated 8 per cent per year.

The bank does not have the right to sell the yacht.

The yacht manufacturer must not recognise revenue from the sale of the yacht.
The substance of the two transactions taken together is that the manufacturer has borrowed CU1,000,000 from the bank and that borrowing is secured by the manufacturer's yacht (inventory asset). Accordingly, the manufacturer must recognise the CU1,000,000 received from the bank as a secured liability and the yacht must remain in the manufacturer's inventory asset.

The CU80,000 (excess of the CU1,080,000 repurchase price over the CU1,000,000 selling price) is recognised as an expense (finance costs) over the period of the loan on the effective interest method.

Ex 9 **The facts are the same as in example 8. However, in this example, the manufacturer has an option (not an obligation) to repurchase the yacht from the bank for CU1,080,000 one year after the sale.**

Because the fair value of the yacht is significantly higher than the strike price of the option to repurchase the yacht, the manufacturer is most unlikely to let the option lapse. Consequently, the substance of the two transactions taken together is that the

manufacturer has borrowed CU1,000,000 from the bank and that borrowing is secured by the manufacturer's yacht (inventory asset). Accordingly, the manufacturer must recognise the CU1,000,000 received from the bank as a secured liability and the yacht must remain in the manufacturer's inventory asset.

The CU80,000 (excess of the CU1,080,000 repurchase price over the CU1,000,000 selling price) is recognised as an expense (finance costs) over the period of the loan on the effective interest method.

Prudence

2.9 The uncertainties that inevitably surround many events and circumstances are acknowledged by the disclosure of their nature and extent and by the exercise of **prudence** in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses. In short, prudence does not permit bias.

Notes

To be a faithful representation, a depiction must be neutral (ie without bias). Prudence does not permit bias. It simply requires a degree of caution in the exercise of judgement. Consequently, management cannot deliberately reflect conservative estimates of assets, liabilities or income.

An admonition to be prudent is likely to lead to a bias—understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—which is a result that cannot be described as prudent or neutral. The IASB does not attempt to encourage or predict specific actions of users. If financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral.

Completeness

2.10 To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Notes

A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description of what the numerical depiction represents (for example, original cost, adjusted cost or fair value). For some items, a complete depiction may also entail explanations of significant facts about the quality and nature

of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction.

Comparability

2.11 Users must be able to compare the financial statements of an entity through time to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events and conditions must be carried out in a consistent way throughout an entity and over time for that entity, and in a consistent way across entities. In addition, users must be informed of the **accounting policies** employed in the preparation of the financial statements, and of any changes in those policies and the effects of such changes.

Notes

Relevant and faithfully represented information is most useful if it can be readily compared with similar information reported by other entities and by the same entity in other periods. One of the most important reasons that financial reporting standards are needed is to increase the comparability of reported financial information. However, relevant and faithfully represented information is still useful even if it is not readily comparable. Comparable information, however, is not useful if it is not relevant and may mislead if it is not faithfully represented. Consequently, *comparability* is considered to be an enhancing qualitative characteristic rather than a fundamental qualitative characteristic.

The need for comparability of financial data over time implies that the measurement and display of the financial effect of like transactions needs to be the same over time. The need for comparability of financial data between entities means that the financial effect of like transactions should be similar. Accounting standards try to ensure the comparability of the data over time and between entities.

The comparability of financial data should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an entity to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an entity to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

An important implication of the qualitative characteristic of comparability is that users must be informed of the accounting policies that have been used in the preparation of the financial statements, any changes in those policies and the effects of such changes. Including the disclosure of the accounting policies used by the entity helps to achieve comparability.

Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different. Comparability of financial

information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different.

Timeliness

2.12 To be relevant, financial information must be able to influence the economic decisions of users. **Timeliness** involves providing the information within the decision time frame. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the needs of users in making economic decisions.

Notes

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

Timeliness is very desirable, but it is not as critical as relevance and faithful representation (ie complete, neutral and free from error). Timely information is useful

only if it is relevant and faithfully represented. In contrast, relevant and faithfully represented information may still be useful (especially for confirmatory purposes) even if it is not reported in as timely a manner as would be desirable.

Balance between benefit and cost

2.13 The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is substantially a judgemental process. Furthermore, the costs are not necessarily borne by those users who enjoy the benefits, and often the benefits of the information are enjoyed by a broad range of external users.

2.14 Financial reporting information helps capital providers make better decisions, which results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. Individual entities also enjoy benefits, including improved access to capital markets, favourable effect on public relations, and perhaps lower costs of capital. The benefits may also include better management decisions because financial information used internally is often based at least partly on information prepared for general purpose financial reporting purposes.

Notes

Cost is a pervasive constraint that the IASB keeps in mind when considering the benefits of a possible new financial reporting requirement—reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

There are several types of costs and benefits to consider. Providers of financial information expend most of the effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur the costs of analysing and interpreting the information provided. If information that users need is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.

Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender or other creditor also receives benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.

In developing the *IFRS for SMEs* the IASB made simplifications from full IFRSs on the basis of users' needs and cost-benefit analyses. In practice, the benefits of applying accounting standards differ across reporting entities, depending primarily on the nature, number and information needs of the users of their financial statements. The related costs may not differ significantly. Consequently, consistently with the *Conceptual Framework*, the IASB concluded that the cost-benefit trade-off should be assessed from the viewpoint of the information needs of the users of an entity's financial statements.

Since adopting the *Conceptual Framework*, application of the cost constraint has resulted in requirements that do not maximise the qualitative characteristics or other main concepts in Section 2. To maintain a cohesive understanding of IFRSs it is helpful to understand why the IASB concluded that for some requirements it was cost-beneficial not to maximise the qualitative characteristics. Its reasons are usually set out in the Basis for Conclusions that accompanies, but does not form part of, the IFRS.

Elements

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 called the 'elements' of financial statements. The elements that are directly related to the measurement of financial position, which is shown in the statement of financial position (sometimes called the balance sheet), are assets, liabilities and equity. The elements that are directly related to the measurement of performance, which is shown in the statement of comprehensive income, are income and expenses. Income and expenses are defined with reference to changes in assets and liabilities. Consequently, assets and liabilities are the cornerstone elements.

The presentation of the elements in the statement of financial position and the statement of comprehensive income involves a process of subclassification. For example, assets and liabilities may be classified by their nature or function in the business of the entity in order to display information in the manner most useful to users for the purpose of making economic decisions.

Financial position

2.15 The financial position of an entity is the relationship of its assets, liabilities and equity as of a specific date as presented in the **statement of financial position**. These are defined as follows:

(a) An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

(b) A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

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

Notes

General purpose financial statements provide information about the financial position of a reporting entity, which is information about the entity's economic resources (assets) and the claims against the reporting entity (liabilities and equity). Financial statements also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.

Economic resources and claims

Information about the nature and amounts of a reporting entity's economic resources

and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to assess the reporting entity's liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining that financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.

Different types of economic resources affect a user's assessment of the reporting entity's prospects for future cash flows differently. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity's operations.

Because the specific requirements of the *IFRS for SMEs* override the concepts set out in Section 2, statements of financial position that conform to the *IFRS for SMEs* may include items that do not satisfy the definitions of an asset or a liability and are not

shown as part of equity. Similarly, on initial recognition, particular items that meet the definition and recognition criteria for an asset are recognised as an expense (eg development costs that satisfy the definition of an asset are recognised as an expense in accordance with Section 18 *Intangible Assets other than Goodwill*). Even though the definitions of the elements will continue to apply in future reviews of the *IFRS for SMEs*, application of the cost constraint may result in such deviations from the main concepts that underlie the *IFRS for SMEs*. In such cases, to maintain a cohesive understanding of IFRSs it is helpful to understand the IASB's reasons for concluding that it was cost-beneficial not to maximise the main concepts in Section 2. Its reasons are usually set out in the Basis for Conclusions that accompanies, but does not form part of, the IFRS (eg for the IASB's reasons for not requiring the recognition of development costs as an asset, see paragraphs BC113 and BC114 of the Basis for Conclusions on the *IFRS for SMEs*).

2.16 Some items that meet the definition of an asset or a liability may not be recognised as assets or liabilities in the statement of financial position because they do not satisfy the criteria for **recognition** in paragraphs 2.27–2.32. In particular, the expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion before an asset or liability is recognised.

Notes

The effects of applying the recognition criteria to particular assets in a particular way result in, for example, expenditures on internally generated intangible assets (eg internally generated brands) not being recognised as an asset. For example, paragraphs 18.14 and 18.15 specifically prohibit the recognition as intangible assets of brands, mastheads, publishing titles, customer lists and items similar in substance that are internally generated because internally generated intangible items of this type would rarely, and perhaps never, meet the recognition criteria.

Similarly, Section 18 *Intangible Assets other than Goodwill* also clarifies that expenditure on research, training, advertising and start-up activities does not result in the creation of

an intangible asset that can be recognised in the financial statements. Some view this interpretation of the application of the recognition criteria as being too restrictive and arbitrary. The prohibition also reflects the fact that it is sometimes difficult to determine whether there is an internally generated intangible asset distinguishable from internally generated goodwill.

Similarly, the effects of applying the recognition criteria to particular liabilities in a particular way result in, for example, a present obligation for which the possibility of the outflow of resources in settlement is less likely than not (ie 50 per cent or less) not being recognised as a liability (see paragraph 21.12).

Assets

2.17 The future economic benefit of an asset is its potential to contribute, directly or indirectly, to the flow of cash and **cash equivalents** to the entity. Those cash flows may come from using the asset or from disposing of it.

Notes

An entity usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers. Because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence they contribute to the cash flow of the entity. Cash itself renders a service to the entity because of its command over other resources.

2.18 Many assets, for example property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset. Some assets are intangible.

Notes

Physical form is not essential to the existence of an asset—for example, licences, patents, copyrights and customer lists are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity. Most financial assets (see the Glossary) are contractual rights.

Example—cash

Ex 10 **An entity has cash.**

The cash is an asset of the entity—the entity determines the purpose to which the cash is put and thereby expects to generate cash inflows (ie cash renders a service to the entity because of its command over other resources).

Examples—assets with physical form

Ex 11 **An entity owns a machine that manufactures its products.**

The machine is a physical asset that is used in the production of goods that are expected to generate cash inflows from their sale.

Ex 12 **An entity owns a factory building in which it manufactures its products.**

The building is a physical asset that is used in the production of goods that are expected to generate cash inflows from their sale.

Ex 13 **An entity owns a fleet of motor vehicles. The vehicles are used by the sales staff in the performance of their duties.**

The motor vehicles are physical assets used in the supply of goods. The entity expects to recover the carrying amount of the vehicles out of cash inflows generated from the sale of goods.

Ex 14 **An entity that manufactures goods owns a motor vehicle for the exclusive business use of its chief financial officer.**

The motor vehicle is a physical asset used in the administration of the entity. The entity expects to recover the carrying amount of the vehicles out of cash inflows generated from the sale of goods.

Ex 15 **An entity owns a herd of cattle that form the breeding stock of its agricultural activities.**

The cattle are tangible assets used in the production of calves. The entity expects to generate cash inflows from the sale of the calves.

Ex 16 **An entity owns a building that it rents to independent third parties under operating leases in return for rental payments.**

The building is a physical asset used by the entity to earn lease rentals. The entity expects to recover the carrying amount of the building out of the rental cash inflows that it generates.

Examples—assets without physical form

Ex 17 **An entity owns a brand name that it purchased from a competitor. The brand name is legally protected through registration with the local government of a trademark[(4)].**

The brand name (a trademark) is an intangible asset of the entity. It is an asset of the entity—control is evidenced by the legal right and the entity would have purchased the brand name with the expectation that the brand would increase the entity's future revenues either by selling products or by preventing its competitors from selling products (future economic benefits). The asset (brand name) is an intangible asset—it is without physical substance (it is a legal right).

Ex 18 **An entity operates 20 taxis under licence in city A. The taxi licences are transferable to other qualified taxi operators.**

The taxi licences are intangible assets of the entity. The licences are assets of the entity because the entity has control through the legal right to operate 20 taxis in the city to generate future economic benefits from taxi fares. The assets (taxi licences) are without physical substance (they are legal rights).

Ex 19 **Entity A owns 100 ordinary shares that carry voting rights at a general meeting of shareholders of entity B.**

The shares in entity B are an investment asset of entity A—entity A has control over the shares (eg it decides whether to hold or sell them). It expects future dividend cash inflows from the shares and ultimately proceeds from their disposal.

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(4) Trademarks are words, names, symbols or other devices used in trade to indicate the source of a product and to distinguish it from the products of others.

2.19 In determining the existence of an asset, the right of ownership is not essential. Thus, for example, property held on a lease is an asset if the entity controls the benefits that are expected to flow from the property.

Example—assets without ownership

Ex 20 **On 1 January 20X1 an entity entered, as lessee, into a five-year non-cancellable lease of a machine that has an economic life of five years, at the end of which the machine is expected to have no value. At the inception of the lease the present value of the lease payments equals the cash cost of the machine.**

From the inception of the lease the machine is an asset of the lessee—it has control over the machine (eg it decides the purpose to which it is put) and it expects the machine to generate future cash inflows from the sale of goods produced using the machine.

In other words, at the inception of the lease, the lease transfers substantially all the risks and rewards incidental to ownership from the lessor to the lessee. In substance, the lessee owns the asset from the inception of the lease.

Liabilities

2.20 An essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way. The obligation may be either a legal obligation or a **constructive obligation**. A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement. A constructive obligation is an obligation that derives from an entity's actions when:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities, and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Notes

An essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way. In accordance with some jurisdictions' financial reporting requirements a liability called 'general reserves' for unspecified potential or future losses is recognised based on a notion of conservatism or prudence. These are sometimes referred to as provisions. These reserves do not meet the definition of a liability in the *IFRS for SMEs*. Consequently, recognition as liabilities of such 'general reserves' is prohibited.

Similarly, obligations that arise from future actions of the entity, no matter how likely, are not present obligations and therefore do not meet the definition of a liability. For example, it is inappropriate to recognise a liability for expected future losses, because the entity has no present obligation to incur those losses (eg the entity could cease the operations that will generate the future losses). It is important to bear in mind, however, that the expectation of losses may be an indicator that some of the

entity's assets are impaired. Recognition of impairment losses is covered by Section 27 *Impairment of Assets*. In addition, if an entity has entered into an onerous contract (see paragraph 21A.2 in the Appendix to Section 21) under which the entity has an unavoidable obligation to incur a loss, then recognising a liability for that loss is appropriate because it arises from a past event—entering into a binding contract—and not from avoidable future loss-making activities.

Examples—liabilities

Ex 21 **Entity A has a contractual obligation to pay entity B CU10,000 for goods that it purchased on 30 days' credit from entity B on 30 December 20X0.**

The debt instrument (trade payable) is a financial liability of entity A—the purchase of the goods on credit created a contractual obligation (a legal obligation) for entity A to pay (expected cash outflow) entity B.

Ex 22 **Waste from an entity's production process contaminated the groundwater at the entity's plant. In a lawsuit brought against the entity, members of the local community seek compensation for damages to their health as a result of the contamination. The entity acknowledges its wrongdoing and the court is deciding on the extent of the compensation to be awarded to the members of the local community.**

The entity has a liability—at the end of the reporting period the entity has a legal obligation to compensate members of the local community for the damages caused (ie the obligating event). The payment for damages is expected to result in an outflow of cash from the entity.

Ex 23 **Waste from an entity's production process contaminated the groundwater at the entity's plant. In this example there is no court case. However, the entity is required by law to restore the contaminated environment.**

The entity has a liability—at the end of the reporting period it is obliged by law to restore the damage caused to the environment (ie the obligating event). Restoring the environment is expected to result in cash outflows.

Ex 24 **An entity has made a written pledge to contribute a substantial sum of money toward the construction of a new performing arts centre in its community. Executives of the entity appeared in a press conference to announce the pledge. With the entity's consent, the charitable organisation that is building the arts centre has cited the entity's pledge in its materials soliciting additional pledges for construction. Under local law, pledges to charitable organisations are not legally enforceable.**

Although the pledge may not be legally enforceable, by participating in the press

conference and by allowing its name to be used in the solicitation, the entity has indicated that it has accepted an obligation to honour its pledge and has created a valid expectation on the part of the arts centre that it will do so (ie its actions have given rise to a constructive obligation).

The entity has a liability—it has a constructive obligation (ie because of its actions the entity has no realistic alternative but to contribute the substantial sum of money toward the construction of the new performing arts centre).

Examples—not liabilities—no obligating event

Ex 25 **An entity that operates ten petrol stations and owns the land and buildings for those stations chooses not to purchase fire insurance on those buildings but, rather, to 'self insure' in case of fire loss. The entity can estimate reliably the statistical probability of the occurrence and amount of expected fire loss (loss of about CU100,000 once every ten years). The entity wants to recognise a liability of CU10,000 and related expense each year for the next ten years to reflect its expected loss. The entity reasons that the loss is highly probable, the amount can be measured reliably, and if it had purchased insurance it would recognise an expense in each reporting period.**

The fact that the entity has retained the risk of fire does not create an obligation that is recognised as a liability. An entity that purchases insurance has paid to transfer its risk to a third party, and that payment is properly recognised as an asset (prepayment for services) on the date that it is made and is then recognised as an expense in profit or loss over the period in which the insurance coverage is consumed, whether or not there is a fire loss.

A fire at one of the stations would be an event that triggers an impairment test on the fire damaged asset. The impairment test might result in the recognition of an impairment loss in profit or loss.

Ex 26 **A ski resort operator operates in a cyclical business, with 'good years' and 'bad years' depending primarily on the weather. The entity believes that, because of the earnings volatility, it is prudent to defer recognition of a portion of the profit in a 'good year' to the inevitable 'bad year' by recognising a liability in 'good years' and reversing the liability in 'bad years'. The owners of the entity are in full agreement with recognising a liability in the good year. In addition, the local income tax law allows deferral of a portion of the profit in a 'good year' to help ensure that ski resort operators have cash to continue operating in 'bad years'. The amount of the entity's accrual under the *IFRS for SMEs* is based on the tax law.**

At the end of a 'good year' the entity does not have a liability because there is no obligating event—it does not have an obligation to pay anyone anything in expectation of a 'bad year'.

Note: an accrual that is allowed for local income tax purposes is not necessarily the same as an accrual (expense and liability) to be recognised for financial reporting purposes.

Ex 27 **An entity operates an open-cast mine in a jurisdiction where environmental rehabilitation laws state that all mine shafts deeper than 10 metres must be entirely filled in by 31 December 2X20 or the mining company that dug the holes for the shafts will be required to pay a substantial fine.**

The geologists' reports indicate that the entity will be able to extract significant quantities of ore for at least 20 years. The ore is located 15 metres below the surface.

At 31 December 20X0 the entity has not started mining.

At 31 December 20X0 the entity does not have a present obligation. It can avoid both the cost of filling the mine and the fine by abandoning the mining operation before it has dug shafts 10 metres deep.

At 31 December 20X1 the entity has sunk a shaft 5 metres deep. It is highly likely that the entity will mine beyond 10 metres in the future and therefore will be obliged to fill in each shaft.

At 31 December 20X1 the entity does not have a present obligation because the shaft is less than 10 metres deep. It can avoid both the cost of filling the mine and the fine by abandoning the mining operation before it has dug shafts 10 metres deep.

At 31 December 20X2 the entity has sunk a shaft 12 metres deep.

At 31 December 20X2 a present obligation exists (ie the entity has a liability) because the entity is required by law to fill in the shaft that exists deeper than 10 metres. Furthermore, the entity has no realistic alternative to filling in the shaft (or paying the fine).

2.21 The settlement of a present obligation usually involves the payment of cash, transfer of other assets, provision of services, the replacement of that obligation with another obligation, or conversion of the obligation to equity. An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

Equity

2.22 Equity is the residual of recognised assets minus recognised liabilities. It may be subclassified in the statement of financial position. For example, in a corporate entity, subclassifications may include funds contributed by shareholders, retained earnings and gains or losses recognised directly in equity.

Examples—equity

Ex 28 **On 31 December 20X0 an entity had equity share capital of CU100,000 in issue. In 20X1, the entity issued 50,000 equity shares at CU5 per share.**

At 31 December 20X1 the entity's equity included CU350,000 funds contributed by its shareholders (ie CU100,000 at 31 December 20X1 + CU250,000 contributed in 20X1).

Ex 29 **On 1 December 20X1 an entity distributed one of its vehicles to its owner-manager when the vehicle's fair value was CU56,000 and its carrying amount was CU15,000.**

The dividend reduced both equity (owners' claims against the entity) and the value of the entity's assets available to meet lenders' claims against the entity by CU56,000. Consequently, the entity also recognises a gain of CU41,000 upon distributing the vehicle to its owner-manager.

Ex 30 **On 31 December 20X0 entity A acquired 75 per cent of entity B (now its subsidiary) for CU75,000 when the fair value of entity B's net assets was CU100,000.**

On 31 December 20X0 the group derecognises a CU75,000 asset (cash outflow) and recognises the net assets acquired at CU100,000. It also recognises in equity the CU25,000 non-controlling interest in the net assets of a subsidiary. Non-controlling interests represent the residual interest in the net assets of those subsidiaries held by some of the shareholders of the subsidiaries within the group. Consequently, it meets the definition of equity (ie the residual interest in the assets of the entity after deducting all of its liabilities).

Note: a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. An essential characteristic of a liability is that the entity has a present obligation and that an obligation is a duty or responsibility to act or perform in a particular way. The non-controlling interest in the net assets of a subsidiary does not give rise to a present obligation of the group, the settlement of which is expected to result in an outflow of economic benefits from the group.

Ex 31 **Since its formation, 75 per cent of a subsidiary has been owned by the reporting entity (parent) and 25 per cent by an independent third party. In the current reporting period when the subsidiary's equity was CU100,000 (ie share capital of CU1,000 and retained earnings of CU99,000) the parent acquired the remaining 25 per cent of the shares in its subsidiary at their fair value of CU60,000.**

From the group's perspective the purchase of the shares in its subsidiary from the non-controlling interest is a transaction between equity holders. Consequently, no gain or loss results from the transaction. However, the group would derecognise the asset cash (ie CU60,000 paid to the non-controlling interest) and derecognise the CU25,000 equity item non-controlling. Consequently, it would also reduce another component of equity (eg retained earnings) by CU35,000 (ie a reallocation within equity).

Ex 32 **On the retirement of one of the owner-managers of an entity on 31 December 20X0 the entity repurchased the shares held by the retiree for their fair value CU1,000.**

The distribution of CU1,000 cash to buy back shares is a return of capital to shareholders, and is therefore recognised as a decrease in equity.

Note: the entity's own shares are not an asset of the entity. Instead, the shares are an interest in the entity's assets. Consequently, the own shares acquired are not recognised as an asset because they lack the essential feature of an asset—the ability to provide future economic benefits. The future economic benefits usually provided by an interest in shares are the right to receive dividends and the right to gain from an increase in the value of the shares. When a company has an interest in its own shares, it will receive dividends on those shares only if it elects to pay them, and such dividends do not represent a gain to the company, because there is no change in net assets: the flow of funds is simply circular. Although it is true that a company that holds its own shares in

treasury may sell them and receive a higher amount if their value has increased, a company is generally able to issue shares to third parties at (or near) the current market price. Although there may be legal, regulatory or administrative reasons why it is easier to sell shares that are held as treasury shares than it would be to issue new shares, such considerations do not result in a fundamental difference between the two cases.

Ex 33 **The facts are the same as in example 32. However, in this example, on 1 January 20X2 the entity issued the shares to a previously independent third party who simultaneously became an owner-manager of an entity in exchange for CU1,200 (the then fair value of the shares).**

The entity's own shares, while held by the entity, were recognised as a decrease of CU1,000 in equity (see the answer to example 32 above). On 1 January 20X2 the CU1,200 inflow of cash on the transfer of those shares to the incoming owner-manager is recognised as an increase in shareholders' capital, and is therefore recognised as an increase in equity. It follows that no revenue or expense would be recognised from the sale of those shares.

Performance

2.23 **Performance** is the relationship of the income and expenses of an entity during a **reporting period**. This IFRS permits entities to present performance in a single financial statement (a **statement of comprehensive income**) or in two financial statements (an **income statement** and a statement of comprehensive income). **Total comprehensive income** and **profit or loss** are frequently used as measures of performance or as the basis for other measures, such as return on investment or earnings per share. Income and expenses are defined as follows:

(a) **Income** is increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity investors.

(b) **Expenses** are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity investors.

Notes

Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. Information about the return that the entity has produced provides an indication of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources. Information about the variability and components of that return is also important, especially in assessing the uncertainty of future cash flows. Information about a reporting entity's past financial performance and how its management discharged its responsibilities is usually helpful in predicting the entity's future returns on its economic resources.

Income and expenses are defined with reference to the cornerstone elements of assets and liabilities, thereby providing robustness to the concept of accrual accounting that underlies the *IFRS for SMEs*. Financial performance (ie comprehensive income) is

measured as the net of all income and expenses for the period, which are determined by reference to all changes in assets and liabilities in the period (except for those associated with equity transactions). The term comprehensive income (rather than profit or loss or net income) is used because the *IFRS for SMEs* requires some (and permits other) specified items of income and expense to be recognised outside of profit or loss in the statement of comprehensive income. These exceptions are made at the requirements level (ie outside of Section 2) and for reasons outside the concepts set out in Section 2.

2.24 The recognition of income and expenses results directly from the recognition and measurement of assets and liabilities. Criteria for the recognition of income and expenses are discussed in paragraphs 2.27–2.32.

Notes

Information about a reporting entity's financial performance during a period, reflected by changes in its economic resources and claims other than by obtaining additional resources directly from investors and creditors, is useful in assessing the entity's past and future ability to generate net cash inflows. That information indicates the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations, rather than by obtaining additional resources directly from investors and creditors.

Information about a reporting entity's financial performance during a period may also indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows.

Income

2.25 The definition of income encompasses both revenue and gains.

(a) **Revenue** is income that arises in the course of the ordinary activities of an entity and is referred to by a variety of names including sales, fees, interest, dividends, royalties and rent.

(b) **Gains** are other items that meet the definition of income but are not revenue. When gains are recognised in the statement of comprehensive income, they are usually displayed separately because knowledge of them is useful for making economic decisions.

Examples—revenue or gain?

Ex 34 **On 31 December 20X5 an entity sold inventory for CU1,500 when the carrying amount of the inventory was CU1,000.**

On 31 December 20X5 the entity recognises CU1,500 income (*revenue* from the sale of goods) and CU1,000 expense (costs of goods sold). (See also paragraph 13.20.)

Ex 35 **On 31 December 20X5 an entity sold a machine used by the entity in the manufacture of goods for CU1,500 when the carrying amount of the machine was CU1,000.**

On 31 December 20X5 the entity recognises a *gain* on the disposal of the machine of CU500 (see also paragraphs 17.28 and 17.30).

Calculation: CU1,500 selling price less CU1,000 carrying amount derecognised on sale = CU500 gain on disposal of machine. Note: the gain is a net amount (ie income less expense).

Ex 36 **A chain of bicycle shops holds bicycles for short-term hire and for sale. The bicycles available for hire are used for two or three years and then sold by the shops as second-hand models.**

All shops sell both new and second-hand bicycles.

The shops have three sources of revenue: (i) the sale of new bicycles, (ii) the sale of second-hand bicycles and (iii) the rental of bicycles.

The sale of a second-hand bicycle is not a disposal of property, plant and equipment, even though the bicycle is held for use by the shops for a number of years in their hire business. The bicycle shops are in the business of selling both new and second-hand bicycles. Consequently, selling second-hand bicycles is part of the shops' ordinary, recurring activities and hence income from such sales represents revenue.

Expenses

2.26 The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity.

(a) **Expenses** that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, or property, plant and equipment.

(b) **Losses** are other items that meet the definition of expenses and may arise in the course of the ordinary activities of the entity. When losses are recognised in the statement of comprehensive income, they are usually presented separately because knowledge of them is useful for making economic decisions.

Examples—expense or loss?

Ex 37 **On 31 December 20X5 an entity sold inventory for CU900 when the carrying amount of the inventory was CU1,000.**

On 31 December 20X5 the entity recognises CU900 income (revenue from the sale of goods) and CU1,000 *expense* (costs of goods sold) (see also paragraph 13.20).

Ex 38 **On 31 December 20X5 an entity sold a machine used by the entity in the manufacture of goods for CU900 when the carrying amount of the machine was CU1,000.**

On 31 December 20X5 the entity recognises a *loss* on the disposal of the machine of CU100 in profit or loss (see also paragraphs 17.28 and 17.30).

Calculation: CU900 selling price less CU1,000 carrying amount derecognised on sale = CU100 loss on disposal of machine. Note: the loss is a net amount.

Recognition of assets, liabilities, income and expenses

2.27 Recognition is the process of incorporating in the financial statements an item that meets the definition of an asset, liability, income or expense and that satisfies the following criteria:

(a) it is **probable** that any future economic benefit associated with the item will flow to or from the entity, and ***[Refer: paragraph 2.29]***

(b) the item has a cost or value that can be measured reliably. ***[Refer: paragraph 2.30]***

[Refer also: paragraphs 2.35–2.45]

2.28 The failure to recognise an item that satisfies those criteria is not rectified by disclosure of the **accounting policies** used or by **notes** or explanatory material.

The probability of future economic benefit

2.29 The concept of probability is used in the first recognition criterion to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence relating to conditions at the end of the reporting period available when the financial statements are prepared. Those assessments are made individually for individually significant items, and for a group for a large population of individually insignificant items.

Notes

Section 2 does not specify whether the recognition threshold is not satisfied only when there is no probability of a cash flow occurring, or whether a higher level (eg greater than 50 per cent) is necessary to trigger recognition. Consequently, the recognition criteria determined at the requirement level are not consistent across the *IFRS for SMEs*.

Some requirements give effect to this concept by requiring recognition of an item that meets the definition of an element only if it is more likely than not that the future economic benefit associated with the item will flow to or from the entity (eg in determining whether a liability is recognised for a particular present obligation). In such cases, the outcome is binary—if the probability of the outflow is greater than 50 per cent a liability is recognised (conversely, if the probability of the outflow is 50 per cent or less, the obligation is not recognised as a liability, ie it is excluded from the entity’s statement of financial position).

Other requirements require recognition of elements that meet the definition of an element (eg asset or liability) and reflect the uncertainties associated with the likelihood of cash flows occurring in respect of particular rights or obligations in the measurement of that asset or liability—for example, when measuring an item at fair value.

Reliability of measurement

2.30 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability. In many cases, the cost or value of an item is known. In other cases it must be estimated. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When a reasonable estimate cannot be made, the item is not recognised in the financial statements.

2.31 An item that fails to meet the recognition criteria may qualify for recognition at a later date as a result of subsequent circumstances or events.

2.32 An item that fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes or explanatory material or in supplementary schedules. This is appropriate when knowledge of the item is relevant to the evaluation of the financial position, performance and changes in financial position of an entity by the users of financial statements.

Notes

In Section 21 the recognition criterion 'probable' is specified to mean more likely than not (ie the recognition threshold for recognising a liability (provision) for a present obligation is satisfied only when the probability of the outflow is greater than 50 per cent. Consequently, in Section 21, if the probability of the outflow is 50 per cent or less, the present obligation is not recognised as a liability (ie the 'contingent' liability is excluded from the entity's statement of financial position). However, unless the possibility of the outflow of resources is remote, the contingent liability is disclosed in the notes (see paragraph 21.12).

Measurement of assets, liabilities, income and expenses

2.33 Measurement is the process of determining the monetary amounts at which an entity measures assets, liabilities, income and expenses in its financial statements. Measurement involves the selection of a basis of measurement. This IFRS specifies which measurement basis an entity shall use for many types of assets, liabilities, income and expenses.

[Refer: paragraphs 2.34, 2.35 and 2.46–2.51]

Notes

To a large extent, IFRS measurements are based on estimates, judgements and models rather than on exact depictions. Section 2 establishes the concepts that underlie those estimates, judgements and models.

When an asset or a liability is measured by reference to future cash flows and the future cash flows are uncertain (ie there is a range of possible outcomes) it is necessary to reduce the range of possible outcomes to a single measure (eg an expected value). The expected value of a distribution of outcomes is its arithmetic mean (ie the probability-weighted sum of the outcomes). For example, a transaction has three possible outcomes:

- 40 per cent probability of CU100 cash flow
- 30 per cent probability of CU200 cash flow
- 30 per cent probability of CU500 cash flow.

The expected value of the cash flow is (40 per cent × CU100) + (30 per cent × CU200) + 30 per cent × CU500) = CU250.

The expected value technique is one of the building blocks to compute a current value of an asset or liability when that amount is not directly observable. The *IFRS for SMEs* requires entities to measure particular assets and liabilities at expected value, or specifies a measurement objective (such as fair value) that can be satisfied using expected value techniques. Examples include:

- measuring a contingent liability in accordance with Section 19 *Business Combinations and Goodwill*;
- measuring a provision involving a large population of items in accordance with Section 21 *Provisions and Contingencies*; and
- measuring value in use in accordance with Section 27 *Impairment of Assets*.

There are usually risks and uncertainties about the amounts, timings and probabilities assigned to the expected cash flows. Those risks and uncertainties can be captured either in estimates of cash flows or in the interest rates. However, the same uncertainties must not be captured in both (ie do not double count risks).

2.34 Two common measurement bases are historical cost and fair value:

(a) For assets, **historical cost** is the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire the asset at the time of its acquisition. For liabilities, historical cost is the amount of proceeds of cash or cash equivalents received or the fair value of non-cash assets received in exchange for the obligation at the time the obligation is incurred, or in some circumstances (for example, income tax) the amounts of cash or cash equivalents expected to be paid to settle the liability in the normal course of business. Amortised historical cost is the historical cost of an asset or liability plus or minus that portion of its historical cost previously recognised as expense or income.

(b) **Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Notes

Other measurement methods required or permitted for particular assets and liabilities in the *IFRS for SMEs* include the equity method for investments in associates, estimated selling price less costs to sell for impaired inventories and value in use for impaired non-current assets.

Sometimes individual assets (and liabilities) are measured using a combination of measurement methods. For example, when the commodity price risk of a commodity held is hedged, the change in the fair value of the commodity held (related to the commodity price risk) is adjusted to the carrying amount (cost) of the commodity held.

Paragraphs 11.27–11.31 provide guidance on how to measure the fair value of financial instruments. That guidance is also useful for measuring the fair value of other assets and liabilities.

Pervasive recognition and measurement principles

2.35 The requirements for recognising and measuring assets, liabilities, income and expenses in this IFRS are based on pervasive principles that are derived from the IASB *Framework for the Preparation and Presentation of Financial Statements* and from full IFRSs. In the absence of a requirement in this IFRS that applies specifically to a transaction or other event or condition, paragraph 10.4 provides guidance for making a judgement and paragraph 10.5 establishes a hierarchy for an entity to follow in deciding on the appropriate accounting policy in the circumstances. The second level of that hierarchy requires an entity to look to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles set out in this section.

Notes

Alternatives are available for all aspects of financial reporting, including recognition, derecognition, measurement, classification, presentation and disclosure. When developing financial reporting standards, the IASB chooses the alternative that goes furthest towards achieving the objective of financial reporting.

Providers of financial information also choose among the alternatives if there are no applicable requirements available (as set out in paragraph 2.35), or if application of a particular standard requires judgements (for examples see the significant estimates and other judgements section of each module of this training material) or options (for examples see paragraphs 3.17–3.19, 7.7, 9.26, 14.4, 15.9 and 35.10), to achieve the objective of financial reporting.

The qualitative characteristics of useful financial information identify the characteristics of information that are likely to be most useful to the existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report. Consequently, subject to the cost-benefit constraint, maximising the qualitative characteristics of financial information guides the judgements needed to apply the objective of financial reporting.

The most critical qualitative characteristics are relevance and reliability (faithful representation). Other qualitative characteristics are less critical but still highly desirable.

In accordance with paragraph 10.4 when the *IFRS for SMEs* does not specifically address a transaction, other event or condition, an entity must select an accounting policy that results in relevant and reliable information. In making that judgement, in accordance with paragraph 10.5 an entity considers, first, the requirements and guidance in the *IFRS for SMEs* dealing with similar and related issues and, second, the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles in Section 2. If that does not provide guidance, the entity may look to the requirements and guidance in full IFRSs, including Interpretations of IFRSs, dealing with similar and related issues (Refer: Basis for Conclusions on the *IFRS for SMEs* paragraph BC86).

When setting its accounting policy in accordance with paragraph 10.4, the entity would usually go through the following steps (subject to the effects of enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

Examples—developing an accounting policy when the *IFRS for SMEs* does not specify particular accounting

Ex 39 **On 1 January 20X7, as part of a scheme to provide support for projects to help rural communities, a non-government development agency announced a plan whereby during 20X7–20X9 entities can apply for a grant of CU50,000 to set up farming operations in a specified rural area Entities must complete an application form, submit their proposal and provide specified documents, which the development agency will consider before issuing the grant.**

The *IFRS for SMEs* does not explicitly specify how to account for a grant from a non-government development agency.

Because the *IFRS for SMEs* does not specify how to account for a grant from a non-government development agency management must develop the entity's accounting policy in accordance with paragraphs 10.4 and 10.5 that results in information that is relevant and reliable.

Relevant financial information is capable of making a difference in the decisions made by users. Information about the nature and amount (fair value) of the grant from a non-government development agency and any unfulfilled conditions and other contingencies attached to the grant would be relevant to the decisions made by users of the entity's financial statements (eg existing and potential investors, lenders and other creditors). The fair value of the grant received is known (ie CU50,000 received). That information is reliable (eg faithful representation, neutral and free from material error).

In developing the entity's accounting policy management would, in accordance with paragraph 10.5(a), refer to Section 24 *Government Grants*. By analogy, grants received from non-government development agencies should be accounted for in accordance with the requirements of Section 24. Consequently, a grant that does not impose future performance conditions on the entity is recognised in income when the grant proceeds are receivable. Similarly, a grant that imposes specified future performance conditions on the entity is recognised in income only when the performance conditions are met (in this case, when the farming operations have been set up in the specified rural area). Grants received before the income recognition criteria are satisfied are recognised as a liability.

Ex 40 **On 1 January 20X7, instead of distributing its excess cash to its shareholders, an entity acquired gold bullion for CU50,000. The entity holds the gold for capital appreciation rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) sale in the ordinary course of business.**

The *IFRS for SMEs* does not explicitly specify how to account for the gold bullion held for capital appreciation.

Because the *IFRS for SMEs* does not specify how to account for the entity's investment in gold bullion management must develop the entity's accounting policy in accordance with paragraphs 10.4 and 10.5 that results in information that is relevant and reliable.

Relevant financial information is capable of making a difference in the decisions made by users. Information about the gold bullion's current market value would be relevant to the decisions made by users of the entity's financial statements (eg existing and potential investors, lenders and other creditors). The current market value of gold bullion is readily obtainable on a continuous basis without undue cost or effort—it is publicly traded in a deep and active market. Consequently, that information is reliable (faithful representation, neutral and free from material error).

In developing the entity's accounting policy for the investment in gold bullion, management would, in accordance with paragraph 10.5(a) refer to Section 16 *Investment Property* that specifies how to account for investment property—ie property (land or buildings, or both) held to earn rentals or for capital appreciation or both. By analogy, the investment in gold bullion should be accounted for in accordance with the requirements of Section 16. Consequently, the entity should recognise its investment in the gold bullion as a separate class of asset. That asset should initially be measured at cost. Thereafter, the asset should be measured at its fair value with changes in its fair value recognised in profit or loss in the period in which the changes occur.

Accrual basis

2.36 An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting. On the accrual basis, items are recognised as assets, liabilities, equity, income or expenses when they satisfy the definitions and recognition criteria for those items.

Notes

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources (assets) and claims (liabilities) in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims, and changes in its economic resources and claims during a period, provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

The primary financial statement elements (assets and liabilities) are the 'building blocks' of financial reporting that conforms to the *IFRS for SMEs*. All other elements (equity, income and expenses) are defined with reference to assets and liabilities, thereby providing robustness to the concept of accrual accounting that underlies the *IFRS for SMEs*.

Without the accrual basis of accounting, management would have wide discretion in determining profit for the period. For example, in years of unusually high profitability management might be tempted to smooth earnings by creating a provision for maintenance work for which no present obligation exists at the reporting date. Conversely, in years of unusually low profitability management might be tempted to increase profit falsely by reversing part of that provision. The *IFRS for SMEs* does not permit this practice—in the absence of a present obligation as a result of a past event (sometimes called the obligating event) there is no liability to recognise.

Recognition in financial statements

Assets

2.37 An entity shall recognise an asset in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. An asset is not recognised in the statement of financial position when expenditure has been incurred for which it is considered not probable that economic benefits will flow to the entity beyond the current reporting period. Instead such a transaction results in the recognition of an expense in the statement of comprehensive income (or in the income statement, if presented).

Examples—recognition of assets?

Ex 41 **An entity has developed a formula that it uses to manufacture a unique glue. The glue is the leading adhesive product in the market because of its distinctive mix of chemicals. The special formula is known only by the entity's two owner-managers and hence no competitors have been able to discover and replicate the formula. The formula is not protected by a patent, or by other means. Many competitors have approached the entity to try to purchase the formula.**

The formula meets the definition of an asset of the entity because, although the formula is not protected by legal rights, the entity has control over the formula by keeping the formula a secret from its competitors. However, in accordance with Section 18, internally generated intangible assets are not recognised as assets (see paragraphs 18.4(c), 18.14 and 18.15) because it is often difficult to attribute expenditure directly to a particular intangible asset rather than expenditure to develop the business as a whole.

Ex 42 **An entity has developed a successful brand that allows the entity to charge a premium for its products. The entity continues to spend large amounts of money on maintaining the brand and on developing the brand (eg sponsoring local sports events, sponsoring select cultural events and advertising the brand).**

The costs that are incurred in developing the brand are recognised as an expense as they are incurred (see paragraphs 18.4(c), 18.14 and 18.15) because they do not satisfy the recognition criteria for an asset—they cannot be distinguished from costs incurred in respect of developing the business as a whole.

Ex 43 **An entity acquires a competitor's brand in a separate acquisition for CU100,000. The entity uses the brand to charge a premium for the products that it manufactures.**

The entity recognises the brand acquired from its competitor as an intangible asset. The CU100,000 incurred to acquire the brand satisfies the recognition criteria for an asset (the probability recognition criterion is always considered as being satisfied for intangible assets that are separately acquired—see paragraph 18.7).

Note: amounts that are incurred by the entity for maintaining and improving the brand will be recognised as an expense as incurred (ie expenditures incurred for sponsorships and advertising cannot be separated from costs incurred in respect of the business as a whole—see paragraphs 18.4(c), 18.14 and 18.15).

2.38 An entity shall not recognise a **contingent asset** as an asset. However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.

Examples—contingent assets?

Ex 44 **An entity is taking legal action against its competitor for patent infringement relating to a patent that had been granted to the entity on one of its products. The outcome of the case is uncertain. However, it is probable that the court will order the competitor to pay damages to the entity.**

The entity must disclose the contingent asset as set out in paragraph 21.16 because an inflow of economic benefits is probable, but not virtually certain.

Ex 45 **The facts are the same as in example 44. However, in this example, it is virtually certain that the court will order the competitor to pay damages to the entity.**

The entity must recognise an asset. It is not a contingent asset because the virtual certainty of receiving benefits removes the contingency.

Ex 46 **The facts are the same as in example 44. However, in this example, it is probable that the court will rule in favour of the competitor (ie it is probable that the entity's case will not be successful).**

An asset must not be recognised. Because an inflow of economic benefits is not probable the contingent asset also is not disclosed.

Liabilities

2.39 An entity shall recognise a liability in the statement of financial position when:

(a) the entity has an obligation at the end of the reporting period as a result of a past event,

(b) it is probable that the entity will be required to transfer resources embodying economic benefits in settlement, and

(c) the settlement amount can be measured reliably.

2.40 A **contingent liability** is either a possible but uncertain obligation or a present obligation that is not recognised because it fails to meet one or both of the conditions (b) and (c) in paragraph 2.39. An entity shall not recognise a contingent liability as a liability, except for contingent liabilities of an acquiree in a business combination (see Section 19 *Business Combinations and Goodwill*).

Examples—recognise a liability or disclose a contingent liability?

Ex 47 **In a lawsuit brought against an entity, a group of people are collectively seeking compensation for damages to their health as a result of contamination to the nearby land that is believed to be caused by waste from that entity's production process. It is doubtful whether the entity is the source of the contamination because many entities operate in the same area producing similar waste and it is unclear which entity is the source of the leak. The entity denies any wrongdoing because it has taken precautions to avoid such leaks and so it is vigorously defending the case. However, the entity cannot be certain that it has not caused the leak and the true offender will become known only after extensive testing.**
The entity's lawyers expect a court ruling in about two years. If the entity loses the case, compensation is likely to be in the range of CU1 million to CU30 million.

On the basis of the facts above it may be uncertain whether the entity has a present obligation—this is the matter being determined by the court.

If, when taking account of all of the available evidence, it is probable that the entity will successfully defend the court case, then the entity has a possible obligation and hence a contingent liability.

If, when taking account of all of the available evidence, it is probable that the entity will lose the court case then the entity is deemed to have a present obligation, and hence a liability of uncertain timing or amount—a provision.

Ex 48 **The facts are the same as in example 47. However, in this example, the entity (subsidiary) was acquired by another entity (parent) on 31 December 20X1. In this example, taking account of all of the available evidence, it is probable that the entity will successfully defend the court case (ie the entity has a possible obligation and hence a contingent liability).**

On 31 December 20X1, in accordance with Section 19, the group (parent and subsidiary viewed as a single entity) recognises a liability for the possible obligation (contingent liability).

Income

2.41 The recognition of income results directly from the recognition and measurement of assets and liabilities. An entity shall recognise income in the statement of comprehensive income (or in the income statement, if presented) when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

Example—income recognition

Ex 49 **On 1 January 20X1 an entity acquired a property for CU1,000. It rents the property to independent third parties under operating leases in return for rental payments. In 20X1 CU90 lease rentals accrued to the lessee (the tenant paid the CU90 rent to the entity on 1 January 20X2).**

The entity measures investment property, after initial recognition, at fair value. At 31 December 20X1 the fair value of its investment property was CU1,100.

The entity recognises income in the year ended 31 December 20X1 as follows:

- CU90 rental income (ie the increase in the asset (rent receivable)—CU90 at 31 December less nil at 1 January 20X1); and
- CU100 increase in the fair value of its asset (investment property)—CU1,100 at 31 December less CU1,000 at 1 January.

Expenses

2.42 The recognition of expenses results directly from the recognition and measurement of assets and liabilities. An entity shall recognise expenses in the statement of comprehensive income (or in the income statement, if presented) when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

Example—expense recognition

Ex 50 **An entity recognised a liability (provision for a lawsuit) at CU40,000 in its statement of financial position at 31 December 20X1. At 31 December 20X2, the entity remeasured the liability at CU90,000. CU3,000 of the increase in the provision is attributable to the unwinding of the discount (ie the increase in the CU40,000 because it is one year closer to settlement) and the remainder of the**

increase is attributed to better information becoming available on which to base the estimates.

The increase of CU50,000 is recognised as an expense in profit or loss for the year ended 31 December 20X2 (ie CU90,000 at 31 December 20X2 less CU40,000 at 31 December 20X1). Of that CU50,000 expense, CU3,000 is a finance cost and the remaining CU47,000 is a loss from a lawsuit.

Total comprehensive income and profit or loss

2.43 Total comprehensive income is the arithmetical difference between income and expenses. It is not a separate element of financial statements, and a separate recognition principle is not needed for it.

2.44 Profit or loss is the arithmetical difference between income and expenses other than those items of income and expense that this IFRS classifies as items of other comprehensive income. It is not a separate element of financial statements, and a separate recognition principle is not needed for it.

2.45 This IFRS does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or of liabilities regardless of whether they result from applying the notion commonly referred to as the 'matching concept' for measuring profit or loss.

Measurement at initial recognition

2.46 At initial recognition, an entity shall measure assets and liabilities at historical cost unless this IFRS requires initial measurement on another basis such as fair value.

Subsequent measurement

Financial assets and financial liabilities

2.47 An entity measures basic **financial assets** and basic **financial liabilities**, as defined in Section 11 *Basic Financial Instruments*, at amortised cost less impairment, except for 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, which are measured at fair value with changes in fair value recognised in profit or loss.

2.48 An entity generally measures all other financial assets and financial liabilities at fair value, with changes in fair value recognised in profit or loss, unless this IFRS requires or permits measurement on another basis such as cost or amortised cost.

Non-financial assets

2.49 Most non-financial assets that an entity initially recognised at historical cost are subsequently measured on other measurement bases. For example:

(a) An entity measures property, plant and equipment at the lower of depreciated cost and recoverable amount.

(b) An entity measures inventories at the lower of cost and selling price less costs to complete and sell.

(c) An entity recognises an impairment loss relating to non-financial assets that are in use or held for sale.

Measurement of assets at those lower amounts is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.

2.50 For the following types of non-financial assets, this IFRS permits or requires measurement at fair value:

(a) investments in **associates** and **joint ventures** that an entity measures at fair value (see paragraphs 14.10 and 15.15 respectively).

(b) **investment property** that an entity measures at fair value (see paragraph 16.7).

(c) agricultural assets (**biological assets** and **agricultural produce** at the point of harvest) that an entity measures at fair value less estimated costs to sell (see paragraph 34.2).

Liabilities other than financial liabilities

2.51 Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the **reporting date**.

Offsetting

2.52 An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by this IFRS.

(a) Measuring assets net of valuation allowances—for example, allowances for inventory obsolescence and allowances for uncollectible receivables—is not offsetting.

(b) If an entity's normal operating activities do not include buying and selling non-current assets, including investments and operating assets, then the entity reports gains and losses on disposal of such assets by deducting from the proceeds on disposal the **carrying amount** of the asset and related selling expenses.

Examples—offsetting required

Ex 51 **On 1 November 20X5 an entity sold an owner-occupied building with a carrying amount of CU2,000,000 for CU3,500,000. The estate agent retained 10 per cent of the proceeds from the sale as a selling commission. Legal fees in respect of the sale were CU10,000.**

On 1 November 20X5 the entity must, in accordance with paragraphs 17.28 and 17.30, recognise a gain on the disposal of the building of CU1,140,000 in profit or loss.

Calculation: CU3,500,000 selling price less CU350,000 agent's commission less CU10,000 legal fees = CU3,140,000 net disposal proceeds.

CU3,140,000 net disposal proceeds less CU2,000,000 carrying amount = CU1,140,000 gain on disposal of building.

Ex 52 **A defined benefit plan provides a monthly pension of 0.2 per cent of final salary for each year of service. The pension is payable from the age of 65. At 31 December 20X1 the present value of the entity's obligations under the plan was appropriately estimated at CU200,000. Furthermore, the fair value of the plan assets out of which the obligations are to be settled directly was determined at CU180,000 as at 31 December 20X1.**

At 31 December 20X1 the entity must, in accordance with paragraph 28.15, recognise a liability (employee benefit: post-employment benefits) of CU20,000 for its defined benefit plan (ie CU200,000 obligation less CU180,000 plan assets set aside to fund the defined benefit obligation).

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty are useful in assessing the financial position, performance and cash flows of an entity. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Other sections of the *IFRS for SMEs* require disclosure of information about particular judgements and estimation uncertainties.

In many cases, little difficulty is encountered in applying the concepts and pervasive principles in Section 2 of the *IFRS for SMEs*. However, in some cases significant judgement is required (eg in particular circumstances, assessments of materiality, economic substance and the probability of future economic benefit flows might require significant judgements). Moreover, when the *IFRS for SMEs* does not specifically address a transaction, other event or condition, management must use its judgement in developing an accounting policy for that transaction, or other event or condition, that results in information that is relevant to the economic decision-making needs of users and is reliable (eg a faithful representation that is free from bias and complete). The second level of the hierarchy established in paragraph 10.5 requires that management look to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles set out in Section 2.

Materiality assessments

Omissions or misstatements of items are material if they *could*, individually or collectively, influence the economic decisions of users made on the basis of the financial statements. Materiality is entity-specific—information is material if omitting it or misstating it *could* influence decisions that users make on the basis of financial information about a specific reporting entity.

The definition of material implies that an entity need not provide a specific disclosure required by this standard if the information is not material and that an entity's accounting policies need not be applied when the effect of applying them is immaterial. Materiality assessments are made in the context of users that have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.

Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factors.

In their *Manual of Accounting IFRS 2011* PricewaterhouseCoopers lists the following items as often qualifying as material, regardless of their individual size:

- Related party transactions
- A transaction or adjustment that changes a profit to a loss, and vice versa.
- A transaction or adjustment that takes an entity from having net current assets to net current liabilities, and vice versa.
- A transaction or adjustment that affects an entity's ability to meet analysts' consensus expectations.
- A transaction or adjustment that masks a change in earnings or other trends.
- A transaction or adjustment that concerns a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability.
- A transaction or adjustment that affects an entity's compliance with loan covenants or other contractual requirements.
- A transaction or adjustment that has the effect of increasing management's compensation, for example by satisfying requirements for the award of a bonus.
- Changes in laws and regulations.
- Non-compliance with laws and regulations.
- Fines against the entity.
- Legal cases.
- Deterioration in relationships with individual or groups of key suppliers, customers or employees.
- Dependency on a particular supplier, customer or employee.

Applying the materiality concept may require significant judgement.

Substance over form

Transaction and other events and conditions must be accounted for and presented in accordance with the economic substance when the economic reality and the legal form are different. Examples of the application of this concept are found in:

- Section 20 *Leases* for contracts that provide rights to capacity but do not take the legal form of a lease;
- Section 22 *Liabilities and Equit*y, which requires particular puttable ordinary shares to be classified as liabilities of the issuer; and
- Section 23 *Revenue* for identifying the revenue transaction in multiple-element sales and for segmenting and combining construction contracts.

Applying the principles developed from the substance over form concept may require significant judgement.

Probability of future economic benefit flows

When preparing financial statements, the management of an entity must make an assessment of the degree of uncertainty over whether the future economic benefits associated with the item will flow to or from the entity. Those assessments are made individually for individually

significant items, and for a group for a large population of individually insignificant items. Making those estimates may require significant judgement.

Accounting policies

When the *IFRS for SMEs* does not specifically address a transaction, or other event or condition, management must use its judgement in developing an accounting policy for that transaction, or other event or condition, in accordance with paragraphs 10.4 and 10.5 of the *IFRS for SMEs*. In making the judgement described in paragraph 10.4, management may consider the requirements and guidance in full IFRSs dealing with similar and related issues, but is not required to do so.

Example 1
An entity that has operations in multiple jurisdictions chooses to provide financial information by operating segment even though those segment disclosures are not required to comply with the *IFRS for SMEs*. Management uses its judgement in developing and applying the entity's accounting policy for disclosing segment information. Judgements would include identifying segments, measuring segment information in a manner that results in information that is relevant to the economic decision-making needs of users and is reliable (eg a faithful representation that is free from bias and complete in all material respects). In making those judgements management may consider the requirements of IFRS 8 *Operating Segments*, but is not required to do so.

Example 2
An entity has factored some of its accounts receivable with a bank. In purchasing the receivables, the bank has assumed all credit risk up to 15 per cent of the amount of the receivables. The selling entity's experience is that credit losses in its receivables have historically been less than 10 per cent. In deciding whether to account for the factoring as a sale of receivables or a collateralised borrowing, the selling entity must use its judgement to determine whether it has transferred to the bank all of the significant risks and rewards relating to the receivables (see paragraph 11.33(b)). In making the judgement, management may consider the requirements and guidance in full IFRSs, but is not required to do so.

COMPARISON WITH FULL IFRSs

Full IFRSs (see *Framework for the Preparation and Presentation of Financial Statements*) and the *IFRS for SMEs* (see Section 2 *Concepts and Pervasive Principles*) at 9 July 2009 share the same concepts.

The requirements for recognising and measuring assets, liabilities, income and expenses in the *IFRS for SMEs* are based on pervasive principles that are derived from the IASB *Framework for the Preparation and Presentation of Financial Statements* and from full IFRSs.

External users of financial reporting have similar objectives, irrespective of the type of entities in which they invest. Consequently, the objective of general purpose financial reports is the same for all entities. However, in developing the *IFRS for SMEs* the Board made simplifications from full IFRSs on the basis of users' needs and of cost-benefit analyses. In practice, the benefits of applying accounting standards differ across reporting entities, depending primarily on the nature, number and information needs of the users of their financial statements. The related costs may not differ significantly. Consequently, in conformity with the *Conceptual Framework*, the Board concluded that the cost-benefit trade-off should be assessed in relation to the information needs of the users of an entity's financial statements.

TEST YOUR KNOWLEDGE

Test your knowledge of the concepts and pervasive principles that underlie the *IFRS for SMEs* by answering the questions below.

Once you have completed the test check your answers against those set out below this test.

Assume that all amounts are material.

Mark the box next to the most correct statement.

Question 1

The objective of general purpose financial statements prepared in accordance with the *IFRS for SMEs* is:

- ☐ (a) to support the reporting entity's annual tax return
- ☐ (b) to provide the government of the jurisdiction in which the reporting entity operates with financial information for use in government statistics or government planning or both
- ☐ (c) to provide management of the reporting entity with financial information about the reporting entity
- ☐ (d) to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs (eg investors and creditors)

Question 2

Which qualitative characteristics are fundamental to general purpose financial information?

- ☐ (a) relevance and reliability
- ☐ (b) relevance and comparability
- ☐ (c) reliability and comparability
- ☐ (d) prudence and comparability

Question 3

The qualitative characteristic 'prudence' implies that in preparing financial statements management should

- ☐ (a) have a bias toward understating assets and income and overstating liabilities and expenses
- ☐ (b) have a bias toward overstating assets and income and understating liabilities and expenses
- ☐ (c) be neutral (ie no bias) and cautious in the exercise of judgements needed in making estimates
- ☐ (d) if permitted to do so, use full IFRSs rather than the *IFRS for SMEs*

Question 4

Materiality depends on:

☐ (a) the size of the item

☐ (b) the nature of the item

☐ (c) the size of the item or error judged in the particular circumstances

Question 5

Which of the descriptions below best describes the qualitative characteristic 'reliability'?

☐ (a) Information is reliable when it is measured precisely (ie little or no uncertainty in measurement)

☐ (b) Information is reliable when it is measured at historical costs

☐ (c) Information is reliable when it is measured at fair value

☐ (d) Information is reliable when it is free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent

Question 6

Which of the following is not an element for which there is a concept in Section 2?

☐ (a) Asset

☐ (b) Liability

☐ (c) Income

☐ (d) Expense

☐ (e) Other comprehensive income

Question 7

Expenses are recognised in comprehensive income (ie profit or loss or other comprehensive income)

☐ (a) using the matching bases (ie on the basis of a direct association between the costs incurred and the earning of specific items of income)

☐ (b) using an accrual basis of accounting

☐ (c) at the discretion of management

☐ (d) at the discretion of the owners of the entity

Question 8

The accrual basis of accounting that underlies financial information prepared in accordance with the *IFRS for SMEs*:

☐ (a) specifies that expenses are recognised as an expense in the period in which the income they generate is recognised (a matching concept)

☐ (b) specifies that an entity must be conservative in its accounting (ie understate assets and income and overstate liabilities and expenses)

☐ (c) specifies that an element (asset, liability, equity, income and expense) is recognised when it satisfies the definition and recognition criteria for an element

☐ (d) specifies that management discretion determines the timing of the recognition of income and expenses

Question 9

Which of the following satisfies the definition of a liability?

☐ (a) The income generating capacity of a snow ski resort is greatly influenced by the amount of snowfall. Snowfall is erratic. To reduce the volatility in its reported profit, a snow ski resort would like to recognise a liability (and corresponding expense) in years of high snowfall (a provision for warm weather) and release that provision to income in years of low snowfall.

☐ (b) An entity 'self insures' its assets against loss or damage, ie it opens a separate bank account (in the company's name) into which it transfers each month an amount equal to the market rate for damage/loss insurance cover. When the entity suffers damage or loss its uses the money in the separate bank account to restore or replace the damaged or lost item. To reduce volatility in its reported profit, the entity would like to recognise a liability (and corresponding expense) in the period in which it transfers cash into the separate bank account (a provision for self insurance) and decrease that provision when cash is paid out of the separate bank account to replace or restore a damaged or lost item.

☐ (c) An entity is being sued for allegedly breaching the patent of one of its competitors. The entity's legal counsel believes that it to be more likely than not that the entity will lose the case.

☐ (d) All of the above (ie (a) to (c))

☐ (e) None of the above

Question 10

One of the criteria that must be satisfied for a liability to be recognised in an entity's financial statements is that it must be probable that future economic benefits will flow from the entity. Which of the following statements is true?

☐ (a) Probable always means the cash outflow is more likely than not (ie a greater than 50 per cent chance that the outflow of economic benefits will occur)

☐ (b) Probable always means there is a greater than zero per cent probability that the cash outflow will occur

☐ (c) The meaning of probable is not specified in Section 2. Its meaning is specified in other sections of the *IFRS for SMEs*. For example, when measuring an item at fair value (eg derivatives, see section 12) probable means a greater than zero per cent probability. However, when measuring a provision in accordance with Section 21 *Provisions and Contingencies*, probable means more likely than not

Question 11

An entity made an unusually high profit for the year ended 31 December 20X7 because it negotiated a significantly lower cost price for its main raw material at a time when the selling price of its products was rising sharply. Management does not want to make public the unusually high profit because they believe that knowledge of the entity's profitability would result in their customers seeking to negotiate lower selling prices when purchasing goods from the entity. Consequently, management would like to decrease profit for the year by recognising a provision for unforeseen possible expenses.

☐ (a) Because creation of the provision is prudent, it is acceptable accounting

☐ (b) Because creation of the provision is common practice in the jurisdiction in which the entity operates, it is acceptable accounting

☐ (c) Provided the reason for creating the provision is explained in the notes, it is acceptable accounting

☐ (d) Because they do not satisfy the definition of a liability, the entity cannot create a provision for unforeseen possible expenses

Question 12

Recognition criteria determine when to recognise an item. Measurement is determining the monetary amounts at which to measure an item. Uncertainties about the extent of future cash flows:

☐ (a) Only affect the decision about whether to recognise the item

☐ (b) Only affect the estimation of the amount at which to measure the item

☐ (c) Could affect decisions about both whether to recognise an item and the measurement of that item

Question 13

How many measurement bases does the *IFRS for SMEs* specify for the measurement of assets?

- ☐ (a) One—historical cost
- ☐ (b) One—fair value
- ☐ (c) Two—historical cost and fair value
- ☐ (d) Many—including historical cost, fair value, value in use, estimated selling price less costs to complete and sell, and the equity method

Question 14

Rather than distributing its excess cash to its shareholders an entity acquired a rare painting. The painting is held for capital appreciation rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) sale in the ordinary course of business.. The *IFRS for SMEs* does not explicitly specify how to account for investments in paintings. How should the entity account for its investment in the painting?

- ☐ (a) Because the *IFRS for SMEs* does not explicitly specify how to account for an investment in a painting, on initial recognition the entity would recognise the expenditure on the painting as an expense in profit or loss.
- ☐ (b) Because the carrying amount of the painting will be recovered through capital appreciation (or possibly rental to others), the relevant information that users' of the entity's financial statements would want about the painting is its current market value. Consequently, by analogy to the accounting specified for investment property (see Section 16 *Investment Property*) the entity should initially measure the painting at cost and thereafter at fair value, with changes in fair value being recognised in profit or loss.
- ☐ (c) Same as (b). However, if the fair value of the painting cannot be measured reliably without undue cost or effort on an ongoing basis then, by analogy to Section 17 *Property, Plant and Equipment* (which includes investment property whose fair value cannot be determined reliably without undue cost or effort on an ongoing basis) the entity would account for the painting using the cost-depreciation-impairment model.
- ☐ (d) Because the *IFRS for SMEs* does not explicitly specify how to account for an investment in a painting the entity must, in accordance with paragraph 2.46, measure the painting asset at its historical cost and subsequently, in accordance with paragraph 2.49, measure it at cost less impairment.

Answers

Q1	(d) see paragraph 2.2
Q2	(a) see paragraph 10.4 and the notes below paragraph 10.4
Q3	(c) see paragraph 2.9
Q4	(c) see paragraph 2.6
Q5	(d) see paragraph 2.7
Q6	(e) see paragraphs 2.15–2.26
Q7	(b) see paragraph 2.36
Q8	(c) see paragraph 2.36
Q9	(c) see paragraph 2.15 and 2.20
Q10	(c) see paragraphs 2.27, 2.29 and 2.39
Q11	(d) see paragraph 2.20
Q12	(c) see paragraphs 2.27–2.34
Q13	(d) see paragraph 2.34
Q14	(c) see paragraph 2.35

APPLY YOUR KNOWLEDGE

Apply your knowledge of the concepts and pervasive principles in accordance with the *IFRS for SMEs* by solving the case studies below.

Once you have completed the case studies check your answers against those set out below this test.

Case study 1

Entities A and B are identical in every respect. They started trading on 1 January 20X1 and have entered into identical transactions with the same counterparties, are subject to the same events and operate in the same economic environment.

In conformity with the *IFRS for SMEs*, entity A recognised CU50 profit in 20X1 and CU50 profit in 20X2.

Entity B, in error, recognised only CU40 profit in 20X1. If it had not made that error it would have recognised profit of CU50 in 20X1 and CU50 profit in 20X2.

In accordance with Section 10 an entity must retrospectively restate its financial information to correct a prior period error and prospective apply revised accounting estimates.
Required:

Explain, with reference to the objective of financial reporting and the qualitative characteristics of financial information why the *IFRS for SMEs*, requires retrospective restatement for the correction of prior period errors and prospective application for the accounting estimates.

Answer to case study 1

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, financial performance and cash flows that is useful for economic decision-making by a broad range of users (eg existing and potential investors, lenders and other creditors) who are not in a position to demand reports tailored to meet their particular information needs.

The International Accounting Standards Board (IASB) uses the objective and concepts in the *Conceptual Framework* to set financial reporting requirements. Alternatives are available for all aspects of financial reporting, including recognition, derecognition, measurement, classification, presentation and disclosure. For correcting prior period errors at least two alternatives exist:

- Prospective correction (ie entity B would correct the error in the reporting period that it is discovered, ie it would present CU60 profit for 20X2 and CU40 as the comparative amount for 20X1); or
- Retrospective restatement (ie in the comparative information presented for 20X1 in its 20X2 financial statements entity B would restate profit as if the error had never occurred, ie it would present CU50 profit for 20X2 and CU50 as the comparative amount for 20X1).

The qualitative characteristics flow from the objective of general purpose financial statements. They identify the characteristics of information that are likely to be most useful to the existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report. Consequently, subject to the cost-benefit constraint, maximising the qualitative characteristics of financial information guides the judgements needed to apply the objective of financial reporting.

The most critical qualitative characteristics are relevance and reliability (faithful representation). Other qualitative characteristics (eg comparability) are less critical but still highly desirable.

When developing financial reporting standards, subject to the effects of the cost constraint, the IASB chooses the alternative that goes furthest towards achieving the objective of financial reporting. Consequently, the *IFRS for SMEs* requires retrospective restatement to correct prior period errors. Retrospective restatement results in relevant information (CU50 faithfully represents the profit earned by entity B in each of 20X1 and 20X2 in accordance with the *IFRS for SMEs*. It is also neutral and free from error). The resulting information about entity B's financial performance and its financial position would be comparable with other entities that use the same reporting framework, (eg entity A) and would allow users to compare entity B's performance over time (ie to compare 20X2 with 20X1).

Without retrospective restatement, entity B's profit for 20X2 would appear to be 50 per cent higher than its profit for 20X1. This would not faithfully represent its financial performance over time and might lead potential investors to conclude wrongly that entity B is a high-growth company and entity A's growth is only stable over the two-year period.

In conclusion, retrospective restatement of prior period errors is required because it provides a more faithful representation of an entity's financial position and its financial performance, and maximises the other qualitative characteristics of the reporting entity's financial information. Thus it provides users with information that is consistent with the objective of financial reporting.

Case study 2

On 1 January 20X0 SME A purchased a machine for CU1,000,000 to manufacture a chemical. If the machine is serviced when it has produced 50,000 units, it is expected to produce about 100,000 units before it must be scrapped. The service is expected to cost about CU90,000.

The machine is expected to be worthless when it has produced 100,000 units. However, at the earlier of 10 years from its installation or when the machine has produced 100,000 units, SME A is required by law to dismantle the machine and to recycle the dismantled parts. Management intends to use the services of an independent specialist to dismantle and recycle the machine at an expected cost of about CU150,000.

Required:

Explain, with reference to the accrual basis of accounting, how SME A should account for the servicing of the machine and its subsequent dismantling and recycling.

Answer to case study 2

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources (assets) and claims (liabilities) in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

The elements of financial statements are assets, liabilities, equity, income and expenses. Income and expenses are defined with reference to assets and liabilities, which provides robustness to the concept of accrual accounting that underlies the *IFRS for SMEs*.

Without the accrual basis of accounting, management would have wide discretion in determining profit for the period. For example, the management of SME A could smooth earnings by creating a provision for the maintenance work to be carried out at the beginning of 20X5 in 20X1−20X4 when there is no present obligation (ie before SME A has a liability). Conversely, in years of unusually low profitability the management of SME A might be tempted to increase profit falsely by reversing part of that provision. The *IFRS for SMEs* does not permit this practice—in the absence of a present obligation as a result of a past event (sometimes called the obligating event) there is no liability to recognise.

Using the accrual basis of accounting, SME A recognises a liability to service the machine only when the service is performed. When the machine is serviced, SME A becomes obligated to pay for that service (ie it has a legal obligation to remunerate the service provider, and settlement of that obligation will result in an outflow from the entity (eg about CU90,000 cash payment)). Until the service is performed, SME A does not have a present obligation—it could avoid servicing the machine by selling it or by discontinuing its use.

Similarly, SME A recognises a liability to dismantle and recycle the machine when it has a present obligation to do so. By installing the machine, SME A becomes obligated to dismantle and recycle that machine and it is probable that future economic benefits (about CU100,000) will flow from the entity in settlement of that obligation. A corresponding asset is recognised because the cost of dismantling forms part of the cost of the machine. Consequently, the cost to dismantle and recycle the machine is recognised as an expense when the inventory produced by the machine is sold because the part of the machine's useful life consumed in the manufacture of the inventory sold is included in the cost of the inventory sold.

Case study 3

SME A purchased a collection of personal belongings of a famous actress. The entity holds the collection for capital appreciation rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) sale in the ordinary course of business.

Required:

Describe how, in accordance with the *IFRS for SMEs*, SME A would account for its collection.

Answer to case study 3

From the date on which the collection is controlled by SME A (ie from the date on which SME A can sell the collection and it can prevent others from access to the collection) it is an asset of SME A because SME A expects to obtain future economic benefits from the collection (ie capital appreciation ultimately to be realised through sale of the collection).

The *IFRS for SMEs* does not specify explicitly how to account for such a collection acquired as a store of wealth.

Note: the collection is not within the scope of:

- Section 17 *Property, Plant and Equipment*, because it is not held for use in the production or supply of goods or services, for rental to others or for administrative purposes.
- Section 13 *Inventories*, because is not held in the ordinary course of business, is not in the process of production for such sale and nor is it a material or item of supplies to be consumed in the production process or in the rendering of services.
- Section 16 *Investment Property*, because it is not land or a building.
- Section 11 *Basic Financial Instruments* and Section 12 *Other Financial Instrument Issues*, because it is not a financial asset.

Because the *IFRS for SMEs* does not explicitly specify how to account for the collection, SME A must, in accordance with paragraph 2.35, develop an accounting policy that provides relevant and reliable information.

Applying the accrual basis of accounting, the collection would be recognised on the date on which it is first controlled by SME A. From that date it is probable that the future economic benefits to be derived from the collection will flow to the entity. At that date the cost of the asset (ie collection) can be measured reliably (ie its purchase price).

In developing its accounting policy for the measurement of the collection after initial recognition, SME A would analogise to the accounting treatments required by the *IFRS for SMEs* for similar assets.

Consequently, SME A could, by analogy to the requirements in Section 16, account for the collection at fair value, with changes in fair value recognised in profit or loss in the period in which the change occurs. Applying the requirements of Section 16 should provide relevant information that can be determined reliably.