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Framework for the Preparation and Presentation of Financial Statements

The IASB Framework was approved by the IASC Board in April 1989 for publication in July 1989, and adopted IASB in April 2001.

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The Framework has not been amended to reflect the changes made by IAS 1 Presentation of Financial Statements (a revised in 2007).

Preface

Financial statements are prepared and presented for external users by many entities around the world. Although financial statements may appear similar from country to country, there are differences which have probably been by a variety of social, economic and legal circumstances and by different countries having in mind the needs of users of financial statements when setting national requirements.

These different circumstances have led to the use of a variety of definitions of the elements of financial statements; for example, assets, liabilities, equity, income and expenses. They have also resulted in the use of different criteria for recognition of items in the financial statements and in a preference for different bases of measurement. The scope of financial statements and the disclosures made in them have also been affected.

The International Accounting Standards Committee (IASC) is committed to narrowing these differences by seeing harmonised regulations, accounting standards and procedures relating to the preparation and presentation of financial statements. It believes that further harmonisation can best be pursued by focusing on financial statements that are prepared for the purpose of providing information that is useful in making economic decisions.

The Board of IASC believes that financial statements prepared for this purpose meet the common needs of most users. This is because nearly all users are making economic decisions, for example, to:

- (a) decide when to buy, hold or sell an equity investment;
- (b) assess the stewardship or accountability of management;
- (c) assess the ability of the entity to pay and provide other benefits to its employees;
- (d) assess the security for amounts lent to the entity;
- (e) determine taxation policies;
- (f) determine distributable profits and dividends;
- (g) prepare and use national income statistics; or
- (h) regulate the activities of entities.

The Board recognises, however, that governments, in particular, may specify different or additional requirements for their own purposes. These requirements should not, however, affect financial statements published for the benefit of other users unless they also meet the needs of those other users.

Financial statements are most commonly prepared in accordance with an accounting model based on recoverable historical cost and the nominal financial capital maintenance concept. Other models and concepts may be more appropriate in some circumstances to meet the objective of providing information that is useful for making economic decisions although there is presently no consensus for change. This *Framework* has been developed so that it is applicable to a range of accounting models and concepts of capital and capital maintenance.

Introduction

Purpose and status

- 1 This *Framework* sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the *Framework* is to:
 - (a) assist the Board of IASC in the development of future International Accounting Standards and the review of existing International Accounting Standards;
 - (b) assist the Board of IASC in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Accounting Standards;
 - (c) assist national standard-setting bodies in developing national standards;
 - (d) assist preparers of financial statements in applying International Accounting Standards and in identifying areas with topics that have yet to form the subject of an International Accounting Standard;

- (e) assist auditors in forming an opinion as to whether financial statements conform with International Accounting Standards;
- (f) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with International Accounting Standards; and
- (g) provide those who are interested in the work of IASB with information about its approach to the formulation of International Accounting Standards.

2 This *Framework* is not an International Accounting Standard and hence does not define standards for particular measurement or disclosure issues. Nothing in this *Framework* overrides any specific International Accounting Standard.

3 The Board of IASB recognises that in a limited number of cases there may be a conflict between the *Framework* and an International Accounting Standard. In those cases where there is a conflict, the requirements of the International Accounting Standard prevail over those of the *Framework*. As, however, the Board of IASB will be guided by the *Framework* in the development of future Standards and in its review of existing Standards, a number of cases of conflict between the *Framework* and International Accounting Standards will disappear through time.

4 The *Framework* will be revised from time to time on the basis of the Board's experience of working with

Scope

5 The *Framework* deals with:

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

6 The *Framework* is concerned with general purpose financial statements (hereafter referred to as 'financial statements') including consolidated financial statements. Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in mind. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes, are outside the scope of this *Framework*. Nevertheless, the *Framework* may be applied in the preparation of such special purpose reports where their requirements permit.

7 Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, an income statement, a statement of changes in financial position (which may be presented in a variety of ways, for example, as a statement of cash flows or a statement of funds flow) and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about industrial and geographical segments and disclosures about the effects of changes in prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial annual report.

8 The *Framework* applies to the financial statements of all commercial, industrial and business reporting entities, whether in the public or the private sectors. A reporting entity is an entity for which there are users who rely on the financial statements as their major source of financial information about the entity.

Users and their information needs

9 The users of financial statements include present and potential investors, employees, lenders, suppliers, trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:

- (a) *Investors*. The providers of risk capital and their advisers are concerned with the risk inherent in their investments. They need information to help them determine whether

should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.

- (b) *Employees.* Employees and their representative groups are interested in information about the performance and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.
- (c) *Lenders.* Lenders are interested in information that enables them to determine whether their loans and the interest attaching to them, will be paid when due.
- (d) *Suppliers and other trade creditors.* Suppliers and other creditors are interested in information which enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent on the continuation of the entity as a major customer.
- (e) *Customers.* Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.
- (f) *Governments and their agencies.* Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to monitor the activities of entities, determine taxation policies and as the basis for national income and statistics.
- (g) *Public.* Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the results of its activities.

10 While all of the information needs of these users cannot be met by financial statements, there are needs common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements satisfy.

11 The management of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this *Framework*. Nevertheless, published financial statements are based on the information used by management about the financial position, performance and changes in financial position of the entity.

The objective of financial statements

12 The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

13 Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they only portray the financial effects of past events and do not necessarily provide non-financial information.

14 Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace management.

Financial position, performance and changes in financial position

15 The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation. This ultimately determines, for example, the capacity of an entity to pay its employees and suppliers, meet its obligations, repay loans and make distributions to its owners. Users are better able to evaluate this ability if they are provided with information that focuses on the financial position, performance and changes in financial position of an entity.

- 16 The financial position of an entity is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the entity and its capacity in the past to modify these resources is useful in predicting the ability of the entity to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash will be distributed among those with an interest in the entity; it is also useful in predicting how successful the entity is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the entity to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future after taking account of financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.
- 17 Information about the performance of an entity, in particular its profitability, is required in order to predict potential changes in the economic resources that it is likely to control in the future. Information about the entity's performance is important in this respect. Information about performance is useful in predicting the capacity of the entity to generate cash flows from its existing resource base. It is also useful in forming judgement about the effectiveness with which the entity might employ additional resources.
- 18 Information concerning changes in the financial position of an entity is useful in order to assess its financing and operating activities during the reporting period. This information is useful in providing a basis with which to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. In constructing a statement of changes in financial position, funds can be defined in various ways, such as all financial resources, working capital, liquid assets or cash. No attempt is made in the *Framework* to specify a definition of funds.
- 19 Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in an income statement. Information about changes in financial position is provided in financial statements by means of a separate statement.
- 20 The component parts of the financial statements interrelate because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose or provide all the information necessary for particular users. For example, an income statement provides an incomplete picture of performance unless it is viewed in conjunction with the balance sheet and the statement of changes in financial position.

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Notes and supplementary schedules

- 21 The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement. They may include disclosures about the risks and uncertainties affecting the entity, such as any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about geographical and industry segments and the effect on the entity of changing prices may also be provided in the form of supplementary information.

Underlying assumptions

Accrual basis

- 22 In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. On this basis, the effects of transactions and other events are recognised when they occur (and not as cash is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the most useful information about past transactions and other events that is most useful to users in making economic decisions.

Going concern

- 23 The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Qualitative characteristics of financial statements

24 Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

25 An essential quality of the information provided in financial statements is that it is readily understandable to users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activity and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to economic decision-making needs of users should not be excluded merely on the grounds that it may be difficult for certain users to understand.

Relevance

26 To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

27 The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the entity to take advantage of opportunities and its ability to react to adverse situations. The same information also plays a confirmatory role in respect of past predictions about, for example, the way in which the entity will be structured or the outcome of planned operations.

28 Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend payments, security price movements and the ability of the entity to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to predict transactions from financial statements is enhanced, however, by the manner in which information about transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed.

Materiality

29 The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect an assessment of the risks and opportunities facing the entity irrespective of the materiality of the results arising from the new segment in the reporting period. In other cases, both the nature and materiality are important. For example, the amounts of inventories held in each of the main categories that are appropriate to the business.

30 Information is material if its omission or misstatement could influence the economic decisions of users taken 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. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Reliability

31 To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32 Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the entity to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful representation

33 To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should not

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faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the re-date which meet the recognition criteria.

- 34 Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that convey messages that correspond with those transactions and events. In certain cases, the measurement of financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although most entities generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items that disclose the risk of error surrounding their recognition and measurement.

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Substance over form

- 35 If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality rather than their legal form. The substance of transactions and other events is not always consistent with their legal form. For example, an entity may dispose of an asset to a party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (indeed there was a transaction).

Neutrality

- 36 To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the outcome of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

- 37 The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed to make 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, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and therefore, not have the quality of reliability.

Completeness

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

Comparability

- 39 Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be done out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.
- 40 An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies used for transactions and other events used by the same entity from period to period and by different entities.

Compliance with International Accounting Standards, including the disclosure of the accounting policies by the entity, helps to achieve comparability.

- 41 The need for comparability should not be confused with mere uniformity and should not be allowed to be 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 line with the qualitative characteristics of relevance and reliability. It is also inappropriate for an entity to keep accounting policies unchanged when more relevant and reliable alternatives exist.
- 42 Because users wish to compare the financial position, performance and changes in financial position of an entity over time, it is important that the financial statements show corresponding information for the comparable periods.

Constraints on relevant and reliable information

Timeliness

- 43 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. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information is highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

Balance between benefit and cost

- 44 The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. Benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Furthermore, the costs do not necessarily fall on those who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared; for example, the provision of further information to lenders may reduce the borrowing cost to the entity. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, stakeholders in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

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Balance between qualitative characteristics

- 45 In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally it is necessary to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement.

True and fair view/fair presentation

- 46 Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity. Although this *Framework* does not deal directly with such concepts, the application of the principal qualitative characteristics and appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly, such information.

The elements of financial statements

- 47 Financial statements portray the financial effects of transactions and other events by grouping them into classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the income statement are income and expenses. The statement of changes in financial position usually reflects changes in financial position elements and changes in balance sheet elements; accordingly, this *Framework* identifies no elements that are unique to this statement.

48 The presentation of these elements in the balance sheet and the income statement involves a process of classification. 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 purposes of making economic decisions.

Financial position

49 The elements directly related to the measurement of financial position are assets, liabilities and equity. They are defined as follows:

- (a) An asset is a resource controlled by the entity as a result of past events and from which 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.

50 The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 82 to 98. In particular, the expectation that future economic benefits will flow from an entity must be sufficiently certain to meet the probability criterion in paragraph 83 before an asset or liability is recognised.

51 In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to the underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that use an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the balance sheet.

52 Balance sheets drawn up in accordance with current International Accounting Standards may include items that do not satisfy the definitions of an asset or liability and are not shown as part of equity. The definitions set out in paragraph 49 will, however, underlie future reviews of existing International Accounting Standards and the formulation of further Standards.

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Assets

53 The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the generation of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operations of the entity. It may also take the form of convertibility into cash or cash equivalents or a capacity to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

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54 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 purchase them and hence contribute to the cash flow of the entity. Cash itself renders a service to the entity because it is under the command of the entity and hence can be used to command other resources.

55 The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be:

- (a) used singly or in combination with other assets in the production of goods or services to be sold to the entity;
- (b) exchanged for other assets;
- (c) used to settle a liability; or
- (d) distributed to the owners of the entity.

56 Many assets, for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity.

57 Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. 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 which are expected to flow from the property. Although the capacity of an entity to control benefits is usually the result of legal rights, an item

nonetheless satisfy the definition of an asset even when there is no legal control. For example, knowledge obtained from a development activity may meet the definition of an asset when, by keeping that knowledge secret, an entity controls the benefits that are expected to flow from it.

58 The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include patents received by an entity from government as part of a programme to encourage economic growth in an area, or the discovery of mineral deposits. Transactions or events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

59 There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been identified. Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the entity may satisfy the definition of an asset.

Liabilities

60 An essential characteristic of a liability is that the entity has a present obligation. An obligation is a responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom or a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

61 A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. A present obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.

62 The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

- (a) payment of cash;
- (b) transfer of other assets;
- (c) provision of services;
- (d) replacement of that obligation with another obligation; or
- (e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

63 Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods or the use of services give rise to trade payables (unless paid for in advance or on delivery) and the receipt of a loan results in an obligation to repay the loan. An entity may also recognise future rebates based on purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

64 Some liabilities can be measured only by using a substantial degree of estimation. Some entities describe liabilities as provisions. In some countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly so as to include only amounts that can be established without the need to use estimates. The definition of a liability in paragraph 49 follows a broader approach. Thus, when a present obligation involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has not yet been estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

65 Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, in a corporate entity, funds contributed by shareholders, retained earnings, reserves represent

appropriations of retained earnings and reserves representing capital maintenance adjustments may be separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the entity to distribute or otherwise use equity. They may also reflect the fact that parties with ownership interests in an entity have differing relationships to the receipt of dividends or the repayment of contributed equity.

66 The creation of reserves is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection from the effects of losses. Other reserves may be established if national law grants exemptions from, or reductions in, taxation liabilities when transfers to such reserves are made. The existence and size of these legal, statutory and tax reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

67 The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate value of the shares of the entity or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the entity as a whole on a going concern basis.

68 Commercial, industrial and business activities are often undertaken by means of entities such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such entities is often different from that applying to corporate entities. For example, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this *Framework* that deal with equity are appropriate for such entities.

Performance

69 Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the entity in preparing its financial statements. These concepts are discussed in paragraphs 102 to 110.

70 The elements of income and expenses are defined as follows:

- (a) Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- (b) Expenses are decreases in economic benefits during the accounting 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 participants.

71 The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that would need to be met before they are recognised in the income statement. Criteria for the recognition of income and expenses are discussed in paragraphs 82 to 98.

72 Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items of income and expenses, consideration needs to be given to the nature of the entity and its operations. Items that arise from ordinary activities of one entity may be unusual in respect of another.

73 Distinguishing between items of income and expense and combining them in different ways also permits different measures of entity performance to be displayed. These have differing degrees of inclusiveness. For example, an income statement could display gross margin, profit or loss from ordinary activities before taxation, profit or loss from ordinary activities after taxation, and profit or loss.

Income

74 The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends and royalties and rent.

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- 75 Gains represent other items that meet the definition of income and may, or may not, arise in the course of ordinary activities of an entity. Gains represent increases in economic benefits and as such are of a different nature from revenue. Hence, they are not regarded as constituting a separate element in this *Framework*.
- 76 Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long-term assets. When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Gains are often reported net of related expenses.
- 77 Various kinds of assets may be received or enhanced by income; examples include cash, receivables and services received in exchange for goods and services supplied. Income may also result from the settlement of liabilities. For example, an entity may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

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Expenses

- 78 The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. 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 resources such as cash and cash equivalents, inventory, property, plant and equipment.
- 79 Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are different in nature from other expenses. Hence, they are not regarded as a separate element in this *Framework*.
- 80 Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, for example those arising from the effects of increases in the rate of exchange for a foreign currency in respect of the borrowings of an entity in that currency. When losses are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Losses are reported net of related income.

Capital maintenance adjustments

- 81 The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. When increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 102 to 110 of this *Framework*.

Recognition of the elements of financial statements

- 82 Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 83. It involves the description of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals. Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used by notes or explanatory material.
- 83 An item that meets the definition of an element should be recognised if:
- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity and
 - (b) the item has a cost or value that can be measured with reliability.
- 84 In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraphs 29 and 30. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The probability of future economic benefit

85 The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the economic benefits associated with the item will flow to or from the entity. The concept is in keeping with the uncertainty that characterises the environment in which an entity operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available at the time when the financial statements are prepared. For example, when it is probable that a receivable owed to an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognised.

Reliability of measurement

86 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured reliably as discussed in paragraphs 31 to 38 of this *Framework*. In many cases, cost or value is not estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement. For example, the expected proceeds from a lawsuit may not meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is possible for the claim to be measured reliably, it should not be recognised as an asset or as income; the amount of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.

87 An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 83 may qualify for recognition at a later date as a result of subsequent circumstances or events.

88 An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary schedules. Such disclosure is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial performance and changes in financial position of an entity by the users of financial statements.

Recognition of assets

89 An asset is recognised in the balance sheet 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.

90 An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead, the transaction results in the recognition of an expense in the income statement. This treatment does not imply that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant recognition of an asset.

Recognition of liabilities

91 A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionate to unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of income

92 Income is recognised in the income statement when an increase in future economic benefits relating to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in practice, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

93 The procedures normally adopted in practice for recognising income, for example, the requirement that income should be earned, are applications of the recognition criteria in this *Framework*. Such procedures are generally

directed at restricting the recognition as income to those items that can be measured reliably and sufficient degree of certainty.

Recognition of expenses

- 94 Expenses are recognised in the income statement 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. This means, in that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).
- 95 Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly from the same transactions or other events; for example, the various components of expense related to the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this *Framework* does not allow the recognition of expenses in the balance sheet which do not meet the definition of assets or liabilities.
- 96 When economic benefits are expected to arise over several accounting periods and the association with the costs can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of a systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as property, plant, equipment, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.
- 97 An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.
- 98 An expense is also recognised in the income statement in those cases when a liability is incurred with the recognition of an asset, as when a liability under a product warranty arises.

Measurement of the elements of financial statements

- 99 Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.
- 100 A number of different measurement bases are employed to different degrees and in varying combinations in the financial statements. They include the following:
- (a) *Historical cost.* Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, for employee income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
 - (b) *Current cost.* Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
 - (c) *Realisable (settlement) value.* Assets are carried at the amount of cash or cash equivalents that would be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.
 - (d) *Present value.* Assets are carried at the present discounted value of the future net cash inflows that the asset is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liability in the normal course of business.
- 101 The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and liabilities are carried at their present value. Furthermore, some entities use the current cost basis as a response to changes in prices.

the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Concepts of capital and capital maintenance

Concepts of capital

102 A financial concept of capital is adopted by most entities in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

103 The selection of the appropriate concept of capital by an entity should be based on the needs of the users of financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the entity, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, although there may be some measurement difficulties in making the concept operational.

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Concepts of capital maintenance and the determination of profit

104 The concepts of capital in paragraph 102 give rise to the following concepts of capital maintenance:

- (a) *Financial capital maintenance.* Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.
- (b) *Physical capital maintenance.* Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

105 The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the reference by which profit is measured; it is a prerequisite for distinguishing between an entity's return on capital and its return of capital; only inflows of assets in excess of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a loss.

106 The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the entity is seeking to maintain.

107 The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount of capital in excess of that required to maintain the capital at the beginning of the period is profit.

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108 Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

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109 Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

110 The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This *Framework* is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is the intention of the Board of IASC to prescribe a particular model other than in exceptional circumstances, for those entities reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments.

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