**The Purpose of Accounting Standards**

The overall purpose of accounting standards is to identify proper accounting practices for the preparation of financial statements.

Accounting standards create a common understanding between users and preparers on how particular items, for example the valuation of property, are treated. Financial statements should therefore comply with all applicable accounting standards.

**The Role of Accounting Standards**

The content of financial statements is often defined by national laws prescribing what, how, and when disclosures should be made. Such requirements, however, are often high-level with little, if any, detailed guidance on how the requirements should be implemented in practice. The role of accounting standards is therefore to translate high-level principles into reasoned procedures that an entity can apply in practice.

Accounting standards maybe based either on what is commonly referred to as the ‘***rules based*** ***approach’*** or the ‘***principles-based approach***’.

A rules-based approach is exactly as its name suggests, detailed rules on a subject. The rules are developed to cover every possible eventuality. If an item or transaction is not covered by a detailed rule, discretion is granted as to how to account for it in the financial statements. This leads in practice to long and often convoluted standards and can encourage a process best described as ‘loopholing’, where preparers of financial statements attempt to find loopholes in the rules which enable them to ignore the accounting requirements. The standard setters as a result are forced to issue more rules to plug the loophole, and so on.

The US standard setting body, the Financial Accounting Standards Board (FASB) has historically issued standards using the rules-based approach.

A principles-based approach involves explaining the general principles that an accounting standard is based on and then providing practical guidance and explanation on how an entity might meet those principles. While containing many detailed rules, IFRS are set on a principles-based approach.

**Setting International Financial Reporting Standards**

**Standards Setting Process**

The IASB process for developing new standards is set out in the Preface and generally involves the following stages (those marked in italics are always required): [Preface 18]

1. staff review the issues associated with the topic, including the application of the Framework, and carry out a study of national requirements and practices in relation to an issue;
2. exchange views with national standards setters (to establish how acceptable the standard would be in national jurisdictions);
3. consultation with the Standards Advisory Council (SAC) on whether the issue should be added to the IASB’s agenda. The SAC is made up of organisations and individuals with an interest in international financial reporting;
4. the formation of an advisory group with specialist interest and knowledge in the topic;
5. issue of a discussion paper for public comment;
6. the publication of an exposure draft, together with any dissenting opinions held by IASB members and a basis of conclusions. Its content should be approved by at least nine of the fourteen IASB members;
7. the publication of a basis of conclusion with exposure drafts;
8. consideration of all comments received on an exposure draft during the comment period;
9. public hearings about, and field tests of, the exposure draft;
10. issue of a standard together with any dissenting opinions held by IASB members. Its content is required to be approved by at least nine of the fourteen members; and
11. the publication of the standard should include a basis of conclusions and a description of the due process undertaken.

Written contributions are welcomed at all stages in this process. The IASB has a public gallery at its monthly meetings (and observers can log-on to a live web cast of the meetings) which allows interested parties to attend as observers.

The predecessor body to the IASB, the International Accounting Standards Committee (IASC) issued IAS numbers 1 – 41 (although there are gaps in the sequence with some standards being subsequently superseded or withdrawn). The IASB adopted all previously issued standards. Standards issued by the new IASB can be identified as they are prefixed with IFRS rather than IAS.

**Preface to International Financial Reporting Standards**

The Preface sets out the objectives and due process of the IASB. It also explains the scope, authority and timing of the application of IFRS. These issues have been discussed above and in Chapter 1.

The Preface highlights a number of other important matters:

1. that IFRS apply to all general purpose financial statements of all profit oriented entities and are directed to the common information needs of a wide range of users; [Preface 9, 10]
2. the IASB’s objective is to require like transactions and events to be accounted for in a like way and not to permit choices. It recognises that the IASC permitted different treatments for given transactions and events (‘benchmark treatment’ and ‘allowed alternative treatment’) and has the objective to reduce choice; [Preface 12, 13] and
3. standards include paragraphs in bold and plain type. Bold type paragraphs indicate the main principles. However, both types have equal authority [Preface 14].

**The Context for Financial Reporting**

This section examines the context for financial reporting, including its purpose, the needs of users of financial statements and how these are met, and the key principles underlying financial statements. The main areas addressed are outlined in the following diagram:



**What is Financial Reporting?**

**Definition**: ‘Financial reporting’ is the provision of financial information about an entity to external users, that is useful to them in making economic decisions and for assessing the effectiveness of the entity’s management. Typically, this information is made available annually, half-yearly or quarterly and is presented in formats laid down or approved by the governments and other regulators in each national jurisdiction.

**Financial statements**: The principal way of providing financial information to external users is through the annual financial statements. Financial statements are the summary of the performance of an entity over a particular period and its financial position at the end of that period. Financial statements are designed to meet the common needs of a wide range of users, and therefore are not tailored to the needs of any particular user group.

Financial statements comprise four primary statements and the accompanying notes, as set out in IAS 1 ***Presentation of financial statements***.

**The Framework for the Preparation and Presentation of Financial Statements**

The Framework sets out the concepts that underlie the preparation and presentation of financial statements. Such concepts are the foundation on which financial statements are constructed and provide a platform from which standards are developed.

The Framework is important because it [Framework 1]:

1. assists the IASB in the development of new standards and the revision of existing standards;
2. provides a rationale for reducing the number of alternative accounting treatments and promoting harmonisation of accounting standards and regulations;
3. assists national standard setters in developing their national standards on a basis consistent with international principles;
4. assists preparers of financial statements in applying IFRS and general principles;
5. assists auditors in forming an opinion on whether financial statements conform with IFRS;
6. assists users of financial statements in their interpretation of financial statements; and
7. provides information on the work carried out by the IASB.

The Framework is not an accounting standard and it does not contain detailed requirements on how financial statements should be prepared or presented.

**Accountability of management**

Management is accountable for the safekeeping of the entity’s resources and for their proper, efficient and profitable use. Shareholders are interested in information that helps them to assess how effectively management has fulfilled this role, as this is relevant to the decisions concerning their investment and the reappointment or replacement of management.

Financial reporting helps management to meet its need to be accountable to shareholders and also to other stakeholders such as employees or lenders, by providing information that is useful to the users in making economic decisions.

**Financial position, performance and changes in financial position**

All economic decisions should be based on an evaluation of an entity’s ability to generate cash and the timing and certainty of its generation. Information about the entity’s financial position, performance and changes in its financial position provides information to support such decisions. [Framework 12]

Information about an entity’s financial position is provided in a statement of financial position, previously known as a balance sheet.

Profit is used as the measure of financial performance. Information on an entity’s financial performance is provided by the statement of comprehensive income, previously known as the income statement.

Cash flow information provides an assessment of changes in an entity’s financial position and is largely free from the more judgemental issues that arise when items are included in the statement of financial position or statement of comprehensive income.

**Underlying assumptions**

There are two fundamentally important assumptions on which financial statements are based, being the accrual basis of accounting and the going concern basis. Both of these are discussed in IAS 1. However, the fundamental principle of the accrual basis of accounting is that transactions are recorded in the financial statements when they occur, not when the related cash flows into or out of the entity occur. [Framework 22]

Under the going concern basis, financial statements are prepared on the assumption that an entity will continue in operation for the foreseeable future. This basis is important, for example, in the assessment of the recoverability of a non-current asset, which is expected to generate benefits in the ongoing business even if its resale value is minimal. [Framework 23]

**Qualitative Characteristics of Financial Statements**

In deciding which information to include in financial statements, when to include it and how to present it, the aim is to ensure that the information is useful to users of the financial statements in making economic decisions. The attributes that make information useful are known as qualitative characteristics and are described in terms of understandability, relevance, reliability and comparability in the context of the preparation of financial statements. [Framework 24]

**Understandability**

Information in financial statements should be understandable to users. This will, in part, depend on the way in which information is presented.

Financial statements cannot realistically be understandable to everyone, and therefore it is assumed that users have:

1. a reasonable knowledge of business and accounting; and
2. a willingness to study with reasonable diligence the information provided.

**Relevance**

Information is relevant if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions. Relevance has two characteristics: a predictive value and a confirmatory value. Users can make a reasoned evaluation of how management might react to certain future events, whilst information about past events will help them to confirm or adjust their previous assessments.

Information about an entity’s financial position and past performance is often used as the basis for making predictions about its future performance. It is therefore important how information is presented. For example, unusual and infrequent items of income and expense should be disclosed separately.

**Reliability**

Information may be relevant, but unless it is reliable as well it is of little use. Information is considered to be reliable if it does not contain substantial errors that would affect the economic decisions of users and if it represents faithfully the entity’s transactions.

Faithful representation requires that transactions are accounted for, and presented in accordance with, their substance and economic reality, even where this is different from their legal form.

Management should present information which is neutral, i.e. free from bias.

To be reliable, information should also be complete.

**Comparability**

For financial information to be useful, it is important that it can be compared with similar information of previous periods or to that produced by another entity. For information to be comparable, it should be consistently prepared; this can be achieved by an entity adopting the same accounting policies from one period to the next as explained in IAS 8 Accounting policies, changes in accounting estimates and errors.

**Elements of Financial Statements**

The elements included in the financial statements are the building blocks from which financial statements are constructed. These elements are broad classes of events or transactions that are grouped according to their economic characteristics. [Framework 47]

Definitionsof elements

Examples of elements of financial statements:

|  |  |  |  |
| --- | --- | --- | --- |
| **Elements** | **Definition** | **Comment** | **Examples** |
| **Asset** | A resource controlled by an entity “as a result of past events and from which future economic benefits are expected to flow” to the entity | An asset maybe utilised in a business in a number of ways, but all will lead to the generation of future economic benefits (i.e. a contribution to cash flowing to the entity). | Cash, inventories, receivables, prepayments, plant, property and equipment. |
| **Liability** | A present obligation of the entity “arising from past events, the settlement of which is expected to result in an outflow” of an entity’s resources | A liability exists where an entity has a present obligation. An obligation is simply a duty or responsibility to perform in a certain way. It is important to make a clear distinction between a present obligation and a future commitment. | Trade payables, unpaid taxes and outstanding loans. |
| **Equity** | The residual interest in an entity’s assets after deducting all its liabilities | Equity= ownership interest = net assets (i.e. share capital and reserves) | Share capital, retained earnings, revaluation reserve and other reserves. |
| **Income** | Increases in economic benefits not resulting from contributions made by equity holders | Income comprises both revenue and gains. Revenue arises from an entity’s normal operating activities.  Gains are increases in economic benefits as is revenue and therefore are not separately identified within the Framework. | Revenue, revaluations, profit on the sale of a noncurrent asset and interest received on investments. |
| **Expenses** | Decreases in economic benefits not resulting from distributions to equity holders | Expenses include losses, for example write-downs of noncurrent assets. | Material and labour costs, depreciation, interest paid on loans and a write-down of an asset. |

**Recognition of Elements in Financial Statements**

An item is classed as 'recognised' when it is included in the financial statements. [Framework 82]

An item should be recognised if it is probable that there will be an inflow or outflow of economic benefits associated with the asset or liability, and the asset or liability can be measured reliably. [Framework 83]

The assessment of the outcome of an event as being probable is linked with the uncertainty of the business environment in which an entity operates. There is no precise point that can be identified at which an event is assessed as being probable. An entity is instead required to make an assessment based on the facts at the time of the preparation of the financial statements.

An item to be recognised in the financial statements needs to be capable of reliable measurement; however, this does not mean that the amount must be certain, as the use of estimates is permitted.

Revenue should be earned before it is recognised in the statement of comprehensive income. Revenue is earned as increases in assets and decreases in liabilities are recognised from an entity’s activities.

Expenses are recognised when there is a decrease in an asset or an increase in a liability.

Matching is a useful concept that encourages the review of all the aspects of a transaction, as it considers whether an asset arises when a liability is recognised and vice versa. It is a concept that matches expenses with income.

**Measurement in Financial Statements**

For an item or transaction to be recognised in an entity’s financial statements it needs to be measured at a monetary amount. There are several different measurement bases which can be used to recognise items in the financial statements.

The measurement bases referred to in the Framework and commonly used in IFRS are: [Framework 99, 100]

1. **Historical cost**: Assets are recorded at their original cost. Liabilities are recorded at their original amount received or the cash expected to be paid out to settle them;
2. **Current cost**: Assets are recorded at the amount that would have to be paid out at the end of the reporting period for an equivalent asset. Liabilities are recorded at the value that they could be settled for at the end of the reporting period;
3. **Realisable** **or** **settlement** **value:** Assets are recorded at the amount that they could be sold for now and similarly liabilities are recorded at the amount expected to be paid out; and
4. **Present** **value**. This measurement basis involves discounting future cash flows to take account of the time value of money.

Although the Framework includes an explanation of the different measurement options, IFRS are primarily based on historical cost.