

**LEARNING UNIT 3**

**THE CONCEPTUAL  
FRAMEWORK FOR  
FINANCIAL REPORTING  
2018**



## LEARNING OUTCOMES

After you have studied this learning unit, you should be able to do the following:

1. Discuss the objectives, usefulness and limitation of general purpose financial reporting.
2. Define and discuss the qualitative characteristics of useful information.
3. Discuss the information financial statements provides.
4. Define the elements of financial statements.
5. Describe the recognition criteria of the elements of financial statements.
6. Determine when to derecognise all or part of a recognised asset or liability from an entity's statement of financial position.
7. Applying measurement basis to elements of financial statements.
8. Factors to consider when selecting a measurement basis.
9. Discuss presentation and disclosure objectives and principles.
10. Application of classification.
11. Describe the concepts of capital maintenance and the determination of profit.

## OVERVIEW

This learning unit is divided into the following:

- 3.1 Scope and purpose of the Conceptual Framework
- 3.2 The objective of general purpose financial reporting (Chapter 1)
  - 3.2.1 Objective, usefulness and limitations of general purpose financial reporting
  - 3.2.2 Information about a reporting entity's economic resources, claims against the entity and changes in resources and claims
  - 3.2.3 Information about the use of the entity's economic resources
- 3.3 Qualitative characteristics of useful financial information (Chapter 2)
  - 3.3.1 Fundamental qualitative characteristics
  - 3.3.2 Enhancing qualitative characteristics
  - 3.3.3 The cost constraint on useful financial reporting
- 3.4 Financial statements and the reporting entity (Chapter 3)
  - 3.4.1 Financial statements
  - 3.4.2 Reporting entity
- 3.5 The elements of financial statements (Chapter 4)
  - 3.5.1 Definition of an asset
  - 3.5.2 Definition of a liability
  - 3.5.3 Assets and liabilities
  - 3.5.4 Equity
  - 3.5.5 Income and expenses
- 3.6 Recognition and Derecognition (Chapter 5)
  - 3.6.1 The recognition process
  - 3.6.2 Recognition criteria
  - 3.6.3 Derecognition
- 3.7 Measurement (Chapter 6)
  - 3.7.1 Measurement bases
  - 3.7.2 Information provided by particular measurement bases
  - 3.7.3 Factors to consider when selecting a measurement basis
  - 3.7.4 Measurement of equity
- 3.8 Presentation and disclosure (Chapter 7)
  - 3.8.1 Presentation and disclosure as communication tools
  - 3.8.2 Presentation and disclosure objectives and principles
  - 3.8.3 Classification
  - 3.8.4 Aggregation
- 3.9 Concepts of capital and capital maintenance (Chapter 8)
  - 3.9.1 Concepts of capital

- 3.9.2 Concepts of capital maintenance and the determination of profit  
3.9.3 Capital maintenance adjustments

## STUDY

### PRESCRIBED

#### ***Descriptive accounting***

The chapter relevant to the *Conceptual Framework for Financial Reporting 2018*

### RECOMMENDED

#### **IFRS Standards - *The Annotated IFRS® Standards***

Conceptual Framework

## 3.1 Scope and purpose of the Conceptual Framework

The *Conceptual Framework for Financial Reporting 2018 (Conceptual Framework)* is not a standard and hence does not override any Standard or any requirement in a Standard. The Conceptual Framework provides the foundation for Standards that:

- contribute to transparency by enhancing the international comparability and quality of financial information;
- strengthen accountability by reducing the information gap between providers of capital and management; and
- contribute to economic efficiency by helping investors identify opportunities and risks across the world (*par SP1.5*).

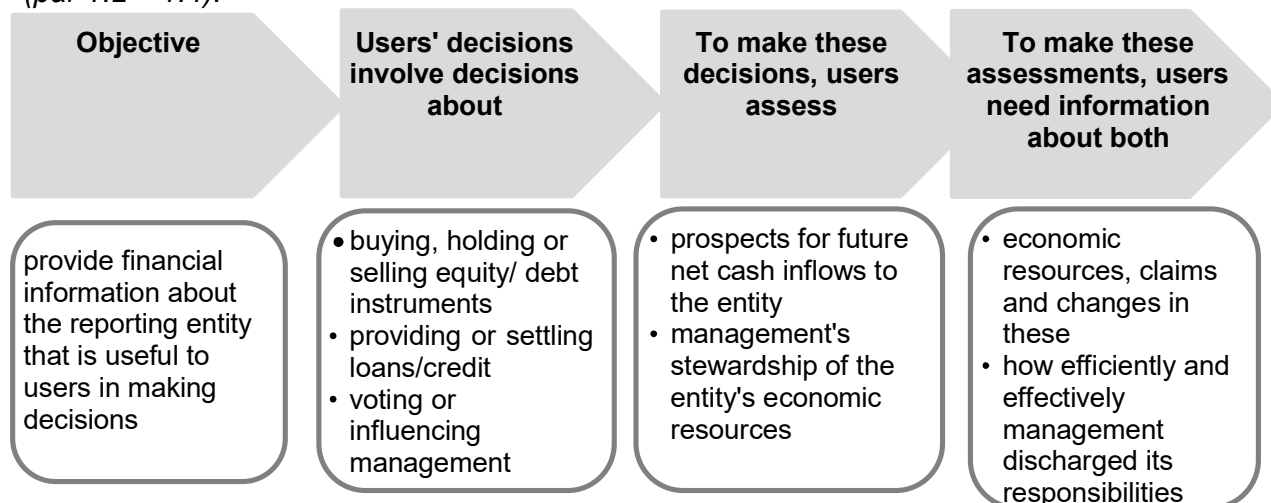
The Conceptual Framework is presented in chapter form and deals with eight chapters.

**Please note that the paragraph numbers in this learning unit are references to paragraph numbers that appear in the *Conceptual Framework*. The *Conceptual Framework* appears as a separate book of *The Annotated IFRS® Standards*.**

## 3.2 The objective of general purpose financial reporting (Chapter 1)

### 3.2.1 Objective, usefulness and limitations of general purpose financial reporting

The diagram below provides the objective of general purpose financial reporting (*par 1.2 – 1.4*):

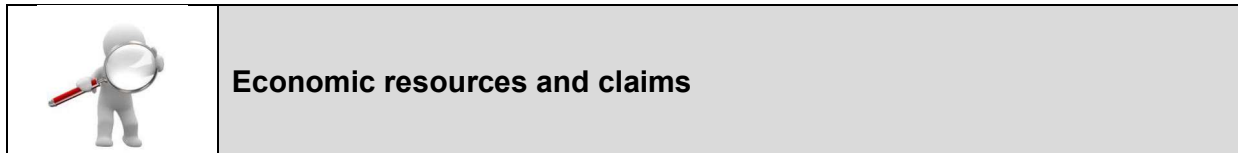


A reporting entity's primary users are the existing and potential investors, lenders and other creditors (users). Many of these users cannot require the reporting entity to provide the required information directly to them and rely on general purpose financial reporting for their information needs (*par 1.5*).

### **3.2.2 Information about a reporting entity's economic resources, claims against the entity and changes in resources and claims**

General purpose financial reports provide the following:

- information about the reporting entity's economic resources (assets) and claims against the entity (liabilities) – otherwise known as the financial position and
- information about the effects of changes in economic resources and claims to the reporting entity's financial position.



Information on a reporting entity's economic resources (assets) and claims (liabilities) help users identify:

- the entity's financial strengths and weaknesses,
- whether the entity is liquid and solvent;
- if the entity needs additional finance (including the likelihood of receiving that finance);
- how management is performing in terms of their stewardship responsibility;
- the current payment arrangements for current claims so that users will be able to determine if the entity will have sufficient future cashflow to make payments for any new claims against the entity (*par 1.13*); and
- nature and amount of the resources available for use in the entity's operations (*par 1.14*)



Changes in economic resources (assets) and claims (liabilities) arise from the entity's financial performance (income and expenses) and other events such as the issue of debt or equity. Users need to assess the effect of these changes on the entity's economic resources (assets) and claims (liabilities) in order to evaluate the future net cash inflows of the entity (*par 1.15*).

#### **Financial performance reflected by ACCRUAL ACCOUNTING**

- Accrual accounting records the effects of transactions on an entity's economic resources and claims in the period in which the economic resources and claims are affected by the transactions and not in the period in which the receipts and payments occur.
- Accrual accounting provides a better basis for assessing the entity's past and future performance than cash based accounting due to the effects of changes on an entity's economic resources and claims (*par 1.17*).

## Financial performance reflected by PAST CASH FLOWS

Information on cash flows during a period assist users:

- to assess the reporting entity's ability to generate future net cash inflows and management's stewardship responsibility,
- to understand how the reporting entity obtains and spends cash, including its borrowings and repayment of debt, cash dividends and other cash distributions to investors, and
- assessing factors that may affect the entity's liquidity or solvency (*par 1.20*).

## Changes in economic resources and claims NOT RESULTING FROM FINANCIAL PERFORMANCE

- There may be changes in the economic resources and claims of a reporting entity that is not due to changes in the entity's financial performance, for example a share issue by the company will generate a cash inflow.
- This information is necessary for users so that they may understand why the reporting entity's economic resources and claims changed, and the implications of those changes on its future financial performance (*par 1.21*).

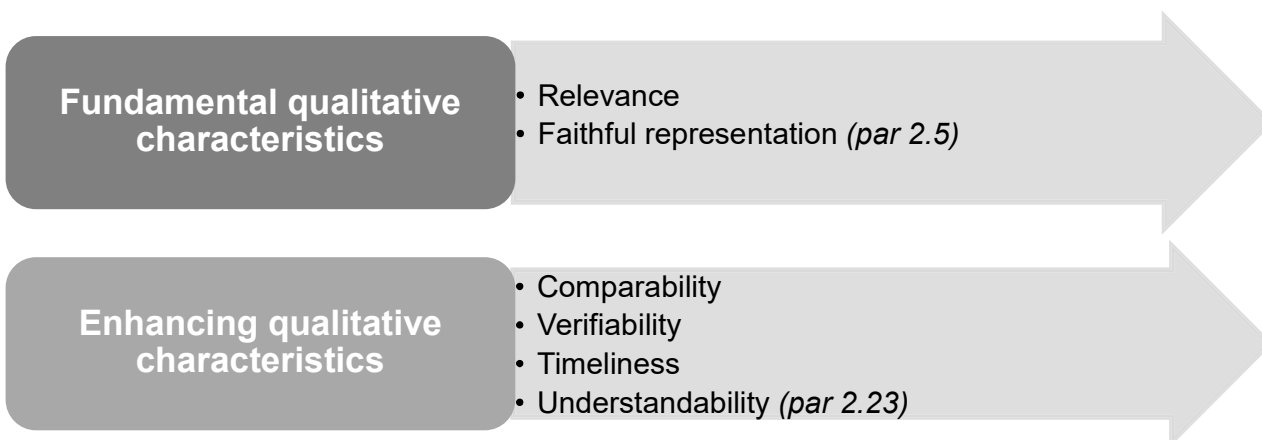
### 3.2.3 Information about the use of the entity's economic resources

Users require information on how the entity's management has discharged its responsibilities so that they can assess if management is effective and efficient in its supervision of the entity's economic resources. The information is also an indication of how management will utilise the entity's economic resources in future periods and consequently its impact on future net cash inflows (*par 1.22*).

## 3.3. Qualitative characteristics of useful financial information (Chapter 2)

The qualitative characteristics of useful financial information discussed in chapter 2 of the *Conceptual Framework* identify the types of information that are likely to be most useful to the existing and potential primary users for making decisions about the reporting entity based on information in its financial report (financial information) (*par 2.1*).

A summary of the qualitative characteristics of financial information are presented in the following table:



### 3.3.1 Fundamental qualitative characteristics

Relevance and faithful representation are the fundamental qualitative characteristics of useful financial information (*par 2.5*). Financial information is deemed to be useful, if it is both relevant and a faithful representation of what it purports to represent. Neither a faithful representation of irrelevant information nor an unfaithful representation of relevant information is useful in decision-making (*par 2.20*).

The following table is a summary of the fundamental characteristics of useful financial information:

Relevance	Faithful representation
<p>Financial information is relevant to users if it can influence the user's decisions (<i>par 2.6</i>). Information makes a difference to user's decision if it has predictive value, confirmatory value or both (<i>par 2.7</i>).</p> <ul style="list-style-type: none"> <li>• Predictive value means that the financial information can be used as an input into a process so that users may predict future outcomes. In other words, users can use the financial information as an input to make their own predictions (<i>par 2.8</i>).</li> <li>• Confirmatory value on the other hand gives feedback on a previous evaluation, by either confirming or changing a previous evaluation (<i>par 2.9</i>).</li> </ul> <p>Materiality is an entity-specific aspect of relevance. Information is material if omitting it or misstating it could influence the decisions made by the primary users based on the provided financial information about that specific reporting entity (<i>par 2.11</i>).</p>	<p>Financial information (words and numbers) must faithfully represent the substance of the information and not merely its legal form. In many cases the substance of information is the same as its legal form. (<i>par 2.12</i>).</p> <p>A perfectly faithful representation of financial information has the following three characteristics:</p> <ul style="list-style-type: none"> <li>• complete</li> <li>• neutral and</li> <li>• free from error (<i>par 2.13</i>).</li> </ul> <ul style="list-style-type: none"> <li>• Complete means including all information necessary for a user to understand the phenomenon being depicted, including descriptions and explanations (<i>par 2.14</i>).</li> <li>• Neutral means that the financial information: <ul style="list-style-type: none"> <li>• is selected and presented without bias</li> <li>• is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that users will receive financial information favorably or unfavorably (<i>par 2.15</i>).</li> </ul> </li> </ul> <p>Neutrality is supported by the exercise of prudence (being the exercise of caution when making judgements under conditions of uncertainty). The exercise of prudence means that assets and income are not overstated, and liabilities and expenses are not understated (<i>par 2.16</i>).</p> <ul style="list-style-type: none"> <li>• Free from error means no errors or omissions in describing the phenomenon, and the process used to produce the information has been selected and applied with no errors in the process. Free from error does not mean accurate in all respects (<i>par 2.18</i>).</li> </ul>

### 3.3.2 Enhancing qualitative characteristics

Comparability, verifiability, timeliness and understandability are the qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented (*par 2.23*). The enhancing qualitative characteristics cannot make information useful if that information is irrelevant or does not provide a faithful representation of what it purports to represent (*par 2.37*).

Comparability enables users to:

- identify and understand similarities and differences amongst items (*par 2.25*)
- decide between available options (examples: selling an investment or retaining it for a longer period; investing in an entity or not) (*par 2.24*)
- compare similar information about the same reporting entity to another period or date (example: comparing current and prior year information) (*par 2.24*).

Verifiability implies that:

- different knowledgeable and independent parties can reach consensus, although not necessarily in complete agreement, that a particular depiction is a faithful representation (*par 2.30*).
- quantified information is both verifiable as a single point estimate or a range of possible amounts and the related probabilities (*par 2.30*).
- verification can be achieved through direct observation (direct) or checking the inputs into a model, formula or other technique and recalculating the outputs (indirect) (*par 2.31*).

Timeliness of information depends on the information:

- older information is generally less useful, BUT
- some information could still be useful over a longer period when it is used for purposes of identifying and assessing trends (*par 2.33*).

Understandability considers:

- inherently complex information to be a part of financial reporting and should not be excluded because it is difficult to understand as this would render information incomplete and possibly misleading (*par 2.34 - 2.35*).
- users to have a reasonable knowledge of business and economic activities and who will review and analyse information diligently (*par. 2.36*)

### 3.3.3 The cost constraint on useful financial reporting

The benefit of providing the information needs to justify the cost of providing and using the information (*par 2.39*)

## 3.4 Financial statements and the reporting entity (Chapter 3)

Chapters 1 and 2 of the *Conceptual Framework* discuss information provided in general purpose financial reports and Chapters 3 to 8 of the *Conceptual Framework* discuss information provided in general purpose financial statements, which are a particular form of general purpose financial reports (*par 3.1*). Chapter 3 of the *Conceptual Framework* describes the objective and scope of financial statements and provides a description of the reporting entity.

### 3.4.1 Financial statements

#### Financial statements

- a particular form of financial reports that provide information about the reporting entity's assets, liabilities, equity, income and expenses

#### Objective and scope of financial statements

The objective of financial statements is to provide financial information about the reporting entity's:

- financial position (assets, liabilities, equity) and
- financial performance (income and expenses).

Financial information must be useful to users of financial statements in assessing

- the prospects for future net cash inflows to the reporting entity and
- management's stewardship of the entity's economic resources (*par 3.2*).

#### Reporting period

The reporting period refers to the period of time covered by the financial statements (example: 1 January 20.18 to 31 December 20.18). Financial statements for a reporting period provide information about:

- assets and liabilities, including unrecognised assets and liabilities, and equity that existed at the end of the reporting period, or during the reporting period; and
- income and expenses for the reporting period (*par 3.4*).

Financial statements present comparative information for at least one reporting period prior the current reporting period to help users recognise and assess changes and trends (*par3.5*).

Financial information may include:

- forward-looking information (being information about possible future transactions and events). Such information is only included if it relates to the entity's assets or liabilities, including unrecognised assets or liabilities, or equity that existed at the end of the reporting period, or during the reporting period, or to income or expenses for the reporting period; and is useful (*par 3.6*); **and**
- information about transactions or events that occurred after the reporting date if it is necessary to meet the objective of financial statements (*par 3.7*).

#### Perspective adopted in financial statements

Financial statements provide information viewed **from the perspective of the reporting entity as a whole**, not from the perspective of any particular group of the entity's existing or potential investors, lenders or other creditors (*par 3.8*).

#### Going concern assumption

Financial statements are normally prepared on the going concern assumption which means that the reporting entity is and will continue in operation for the foreseeable future. This assumption assures users that the entity has neither the intention nor the need to enter liquidation or to cease trading. If such an intention or need exists, the financial

statements may have to be prepared on a different basis. If so, the financial statements describe the basis used (*par 3.9*)

### 3.4.2 Reporting entity

#### A reporting entity

- is an entity that is required, or chooses, to prepare financial statements
- can be a single entity or a portion of an entity or can comprise more than one entity
- is not necessarily a legal entity (*par. 3.10*).

### Consolidated and unconsolidated financial statements

The composition of the reporting entity will determine whether the financial statements will be referred to as:

- Consolidated financial statements (the reporting entity comprises both the parent and the subsidiary);
- Unconsolidated financial statements (the reporting entity is the parent alone); or
- Combined financial statements (the reporting entity comprises two or more entities not all linked by a parent-subsidiary relationship) (*par. 3.11 – 3.12*).

### 3.5. The elements of financial statements (Chapter 4)

Chapter 4 of the *Conceptual Framework* defines the five elements of financial statements – assets, liabilities, equity, income and expenses. The elements discussed in this chapter links back to items discussed in chapter 1. The following table shows the link between the elements and the economic resources, claims and changes in economic resources and claims:

Economic phenomena	Element
Economic resource	Asset
Claim	Liability and Equity
Changes in economic resources and claims, reflecting financial performance	Income and Expenses
Other changes in economic resources and claims	-

#### 3.5.1 Definition of an asset

##### An ASSET is defined as

- a present
- economic resource (refer definition below)
- controlled by the entity
- as a result of past events (*par 4.3*).

An economic resource is defined as

- a right that
- has the potential to produce economic benefits (*par 4.4*).

The following aspects of the above definitions will be discussed:

- Right;
- Potential to produce economic benefits; and
- Control.

	<h2>Right</h2>
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1. *Rights that have the potential to produce economic benefits, include:*

- *rights that correspond to an obligation of another party and*
- *rights that do not correspond to an obligation of another party (par 4.6)*

Examples of rights that correspond to an obligation of another party include:	Examples of rights that do not correspond to an obligation of another party include:
Rights to exchange economic resources with another party on favorable terms (examples: a forward contract to buy an economic resource on terms that are currently favorable or an option to buy an economic resource)	Rights over physical objects, such as property, plant and equipment or inventories. (examples: a right to use a physical object or a right to benefit from the residual value of a leased object)
Rights to receive cash	Rights to use intellectual property (par. 4.6(b))
Rights to receive goods or services	
Rights to benefit from an obligation of another party to transfer an economic resource if a specified uncertain future event occurs (par. 4.6(a))	

2. *Many rights are established by contract, legislation or similar means.*

**Example:**

- An entity might obtain rights from owning or leasing a physical object, from owning a debt instrument or an equity instrument, or from owning a registered patent.

*An entity might also obtain rights in other ways.*

**Example:**

- by acquiring or creating know-how that is not in the public domain; or
- through an obligation of another party that arises because that other party has no practical ability to act in a manner inconsistent with its customary practices, published policies or specific statements. (par 4.7).

3. *Some rights to obtain the economic benefits exist momentarily.*

**Example:**

Employee services are received and immediately consumed. An entity's right to obtain the economic benefits produced by such goods or services exists momentarily until the entity consumes the goods or services (par 4.8).

4. *In principle, each of an entity's rights is a separate asset. However, for accounting purposes, related rights are often treated as a single asset.*

**Example:**

Legal ownership of a physical object may give rise to several rights, including:

- the right to use the object;
- the right to sell rights over the object; and
- the right to pledge rights over the object (*par 4.11*).

5. *In some cases, it is uncertain whether a right exists.*

**Example:**

An entity and another party might dispute whether the entity has a right to receive an economic resource from that other party. Until that existence uncertainty is resolved, for example by a court ruling, it is **uncertain**, whether the entity has a right and, consequently, whether an asset exists (*par 4.13*).



**Potential to produce economic benefits**

Per the definition an economic resource is a right that has the potential to produce economic benefits. It is not necessary for there to be certainty that the right will produce economic benefits. For this potential to exist

- it is necessary for the right to exist; and
- in at least one instance, the right will produce economic benefits beyond those available to other parties. (*par 4.14*).

1. *An economic resource might have a right but the potential to produce economic resources may be low.*

- *The low probability of economic benefits does not prohibit the economic benefit from being an asset, but may affect the following decisions*
- what information to provide about the asset,
- how to provide that information,
- whether the asset is recognised and
- how it is measured (*par4.15*).

2. *An economic resource could produce economic benefits for an entity by entitling or enabling it to do, for example, one or more of the following:*

- receive contractual cash flows or another economic resource;
- exchange economic resources with another party on favourable terms;
- produce cash inflows or avoid cash outflows by, for example:
  - using the economic resource either individually or in combination with others to produce goods or provide services;
  - using the economic resource to enhance the value of other economic resources;
  - or
  - leasing the economic resource to another party;
- receive cash or other economic resources by selling the economic resource; or
- extinguish liabilities by transferring the economic resource (*par4.16*).

3. *An economic resource is the present right that has potential to produce economic benefits. It is not the future economic benefits that the right may produce (par 4.17).*

**Example:**

A purchased option derives its value from its potential to produce economic benefits through exercise of the option at a future date. However, the economic resource is the **present right** - the right to exercise the option at a future date. The economic resource is not the future economic benefits that the holder will receive if the option is exercised.

4. *Incurring expenditure and acquiring assets do not necessarily coincide.*

There is a close association between expenditure incurred and assets acquired but that does not mean that if an entity has incurred expenditure it has acquired an asset, nor does it mean that if no expenditure has been incurred there is no asset that may exist.

Assets can include, for example, rights that a government has granted to the entity free of charge or that another party has donated to the entity (par 4.18).



**Control**

1. *Control links an economic resource to an entity. Assessing whether control exists helps to identify the economic resource for which the entity accounts (par 4.19).*

**Example:**

An entity may control a proportionate share in a property without controlling the rights arising from ownership of the entire property. In such cases, the entity's asset is the share in the property, which it controls, not the rights arising from ownership of the entire property, which it does not control (par. 4.19).

2. *An entity has control over an economic resource if it has the present ability to:*

- direct the use of the economic resource and obtain the economic benefits that may flow from it, therefore it has the right to deploy that economic resource in its activities, or to allow another party to deploy the economic resource in that other party's activities (par 4.20 - 4.21); or
- prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it (par 4.20). In other words, only one party can control an economic resource at a time.

3. *Control of an economic resource usually arises from an ability to enforce legal rights. However, control can also arise if an entity has other means of ensuring that it, and no other party, has the present ability to direct the use of the economic resource and obtain the benefits that may flow from it.*

**Example:**

An entity could control a right to use know-how that is not in the public domain if the entity has access to the know-how and the present ability to keep the know-how secret, even if that know-how is not protected by a registered patent (par 4.22).

4. *For an entity to control an economic resource, the future economic benefits from that resource must flow to the entity either directly or indirectly rather than to another party.*

This aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances. Instead, it means that if the resource produces economic benefits, the entity is the party that will obtain them either directly or indirectly (*par 4.23*).

5. One of the factors to consider in the overall assessment of whether control exists, is whether the entity has *exposure to significant variations in the amount of the economic benefits produced by an economic resource* (*par 4.24*).
6. *Sometimes one party (a principal) engages another party (an agent) to act on behalf of, and for the benefit of, the principal* (*par 4.25*).

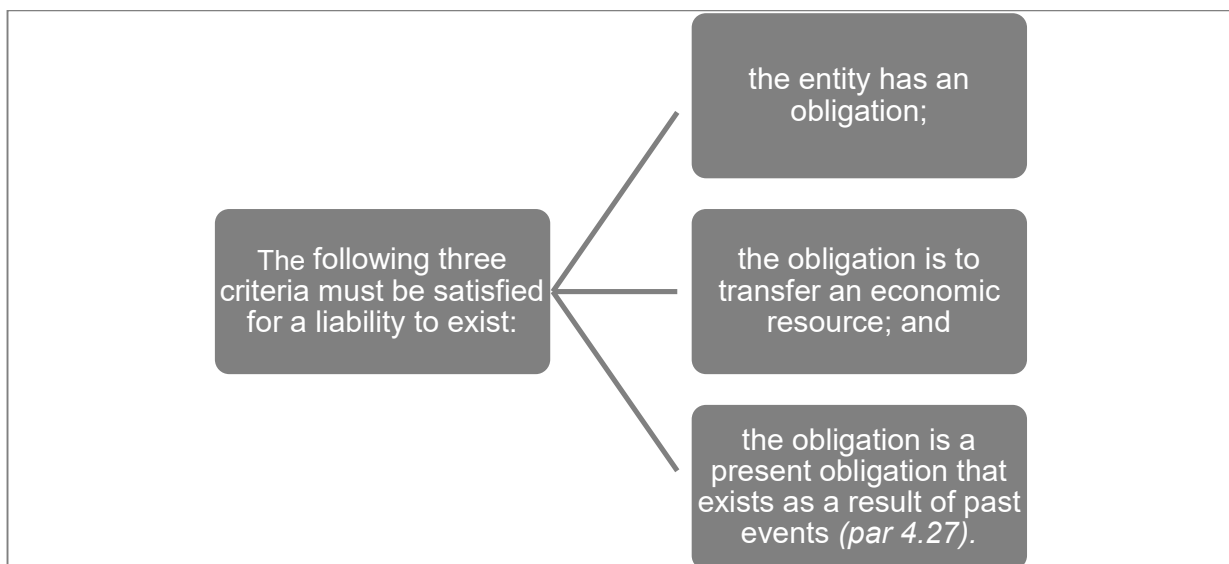
#### **Example:**

A principal may engage an agent to arrange sales of goods controlled by the principal. If an agent has custody of an economic resource controlled by the principal, that economic resource is not an asset of the agent. Furthermore, if the agent has an obligation to transfer to a third party an economic resource controlled by the principal, that obligation is not a liability of the agent, because the economic resource that would be transferred is the principal's economic resource, not the agent's (*par. 4.25*).

### **3.5.2 Definition of a liability**

#### **A LIABILITY is defined as**

- a present obligation of the entity
- to transfer an economic resource
- as a result of past events (*par 4.26*).





## Obligation

The first condition for a liability is that the entity has an obligation (*par 4.28*).

An obligation is a duty or responsibility that an entity has no practical ability to avoid. An obligation is always owed to another party (or parties), irrespective whether that other party (or parties) are known (*par 4.29*).

1. *If one party has an obligation to transfer an economic resource, it follows that another party (or parties) has a right to receive that economic resource.*

However, a requirement for one party to recognise a liability and measure it at a specified amount does not imply that the other party must recognise an asset or measure it at the same amount (*par 4.30*).

2. *Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed.*

*Obligations can also arise from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is referred to as a 'constructive obligation' (par 4.31).*

3. *An entity's duty or responsibility to transfer an economic resource may be conditional on a particular future action that the entity itself may take.*
4. *The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity's duty or responsibility (par 4.34).*

Preparing an entity's financial statements on a going concern basis implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade (*par 4.33*). Neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer.

5. *In some cases, it may be uncertain whether an obligation exists (par 4.35).*

### **Example:**

If another party is seeking compensation for an entity's alleged act of wrongdoing, it might be uncertain whether the act occurred, whether the entity committed it or how the law applies. Until that existence uncertainty is resolved by for example a court ruling, it is uncertain whether the entity has an obligation to the party seeking compensation and, consequently, whether a liability exists.



## Transfer of an economic resource

The second condition for a liability is that the obligation is to transfer an economic resource (*par 4.36*).

The potential must exist for the entity to be required to transfer an economic resource to another party. For the potential to exist it is necessary that:

- the obligation already exists and
- in at least one instance, it would require the entity to transfer an economic resource.

The transfer of an economic resource therefore need not be certain or even likely, for the potential to exist (*par 4.37*).

### Examples of obligations to transfer an economic resource

- obligations to pay cash;
- obligations to deliver goods or provide services;
- obligations to exchange economic resources with another party on unfavourable terms;
- obligations to transfer an economic resource if a specified uncertain future event occurs;
- obligations to issue a financial instrument if that financial instrument will oblige the entity to transfer an economic resource (*par 4.39*).

1. *An obligation can meet the definition of a liability even if the probability of a transfer of an economic resource is low.*

Low probability might however affect decisions about

- what information to provide about the liability,
- how to provide that information,
- whether the liability is recognised and
- how it is measured (*par 4.38*).

2. *Instead of fulfilling an obligation to transfer an economic resource to the party that has a right to receive that resource, entities sometimes decide to:*

- settle the obligation by negotiating a release from the obligation;
- transfer the obligation to a third party; or
- replace that obligation to transfer an economic resource with another obligation by entering into a new transaction (*par 4.40*).

In the above situations, an entity has the obligation to transfer an economic resource until it has settled, transferred or replaced that obligation (*par 4.41*).



## Present obligation as a result of a past events

The third condition for a liability is that the obligation is a present obligation that exists as a result of past events (*par 4.42*).

A present obligation exists as a result of past events only if:

- the entity has already obtained economic benefits (example: goods or services) or taken an action (example: operating a particular business or operating in a particular market) and
- as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer (*par 4.43 – 4.44*).

If economic benefits are obtained, or an action is taken, *over time*, the resulting present obligation may accumulate over that time (*par 4.44*).

If an entity has NOT yet obtained economic benefits or taken an action, as required above, then an entity does NOT yet have a present obligation to transfer an economic resource.

**Example:**

If an entity enters into a contract to pay an employee a salary in exchange for receiving the employee's service, the entity does not have a present obligation to pay the salary until it has received the employee's services. Before then the contract is **executory** as the entity has a combined right and obligation to exchange future salary for future employee services (*par 4.47*).

1. *If new legislation is enacted, a present obligation arises only when, as a consequence of obtaining economic benefits or taking an action, to which that legislation applies, an entity will or may have to transfer an economic resource that it would not otherwise have had to transfer. The enactment of legislation is not in itself sufficient to give an entity a present obligation.*

*Similarly, an entity's customary practice, published policy or specific statement ('constructive obligation') gives rise to a present obligation only when, as a consequence of obtaining economic benefits, or taking an action, to which that practice, policy or statement applies, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer (*par 4.45*).*


2. *A present obligation can exist even if a transfer of economic resources cannot be enforced until some point in the future.*

**Examples:**

- A contractual liability to pay cash may exist now even if the contract does not require a payment until a future date.
- A contractual obligation for an entity to perform work at a future date may exist now even if the counterparty cannot require the entity to perform the work until that future date (*par 4.46*).

**EXAMPLE 1a**

Fastcars Ltd, a manufacturer of motor vehicles received a claim of R750 000 from Mr Xavier, a customer. Mr. Xavier alleges that the motor vehicle sold to Mr Xavier by Fastcars Ltd caught fire due to an electronic circuit fault existing in the motor vehicle. Fastcars Ltd disputes this claim as all motor vehicles sold by Fastcars Ltd are subject to strict quality control manufacturing inspections before they are sold to their customers. The court case proceedings are scheduled for within the next three months.

	<p><b>REQUIRED:</b></p> <p>Discuss if the claim received currently by Fastcars Ltd from Mr Xavier the customer is a liability in terms of the <i>Conceptual Framework</i> definition.</p> <p>Please note that the recognition criteria need not form part of your answer.</p>
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## SOLUTION 1a

### HOW SHOULD I APPROACH THIS QUESTION?

The question here is the following:

- Does a liability exist in respect of the claim?

#### STEP 1: What theory do I need?

Basic theory from the *Conceptual Framework* regarding the definition of a liability is essential knowledge to answer the question. Therefore, provide the definition of a liability:

*A liability is defined as a*

- *present obligation of the entity*
- *to transfer an economic resource*
- *as a result of past events (par 4.26).*

#### STEP 2: Test whether a liability exists (Application)

The conceptual framework identifies certain criteria that needs to be met for a liability to exist. Therefore, provide the criteria:

*For a liability to exist, the claim must meet all three of the following criteria:*

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

Discuss the criteria in terms of the question scenario:

#### **Does the entity have an obligation?**

*An obligation is a duty or responsibility that the entity has no practical ability to avoid (par. 4.29).*

*A legal claim seeking compensation of R750 000 was instituted against Fastcars Ltd and if Fastcars Ltd is found responsible they will have a legally enforceable obligation to compensate Mr Xavier. However, it is uncertain whether Fastcars Ltd has an obligation to Mr Xavier (existence uncertainty) which will only be resolved by a court ruling in the matter.*

*Therefore, it is uncertain whether Fastcars Ltd has an obligation.*

#### **Is the obligation to transfer an economic resource?**

*As no obligation exists, there is no obligation of a transfer of an economic resource to Mr Xavier by Fastcars Ltd.*

#### **Is the obligation a present obligation that exists as a result of past events?**

*There is no past event as no transfer of a potential economic resource to Mr Xavier exists.*

### STEP 3: Conclude

A liability does not exist in respect of the claim because it is uncertain whether Fastcars Ltd has an obligation to the party seeking compensation. Until the existence uncertainty is resolved by the court ruling, the claim does not meet the definition of a liability.

#### EXAMPLE 1b

Refer to the details in Example 1a. However, for the purpose of this example assume that the court found Fastcars Ltd liable for the claim as the electrical circuit of the motor vehicle was found faulty. Fastcars Ltd is a financially stable company.



#### REQUIRED:

Discuss if the claim received currently by Fastcars Ltd from Mr Xavier the customer is a liability in terms of the *Conceptual Framework* definition.

Please note that the recognition criteria need not form part of your answer.

#### SOLUTION 1b

##### HOW SHOULD I APPROACH THIS QUESTION?

The question here is the following:

- Does a liability exist in respect of the claim?

##### STEP 1: What theory do I need?

Basic theory from the *Conceptual Framework* regarding the definition of a liability is essential knowledge to answer the question. Therefore, provide the definition of a liability:

*A liability is defined as a*

- *present obligation of the entity*
- *to transfer an economic resource*
- *as a result of past events (par 4.26).*

##### STEP 2: Test whether a liability exists (Application)

The conceptual framework identifies certain criteria that needs to be met for a liability to exist. Therefore, provide the criteria:

*For a liability to exist, the claim must meet all three of the following criteria:*

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

Discuss the criteria in terms of the question scenario:

##### ***Does the entity have an obligation?***

*An obligation is a duty or responsibility that the entity has no practical ability to avoid (par. 4.29). Fastcars Ltd was found liable for the legal claim seeking compensation of R750 000. Fastcars Ltd has a duty to compensate Mr Xavier which they cannot practically avoid as it is legally enforceable. The existence uncertainty has therefore been resolved.*

##### ***Is the obligation to transfer an economic resource?***

*The potential should exist for the entity to be required to transfer an economic resource to*

another party.

The obligation already exists as Fastcars Ltd was found liable for the claim by the court ruling and are required to compensate Mr Xavier by transferring an amount of R750 000.

**Is the obligation a present obligation that exists as a result of past events?**

Fastcars Ltd will have to transfer R750 000 because the court ruling found them liable for the amount. Therefore, a present obligation exists as a result of a past event (court ruling).

### STEP 3: Conclude

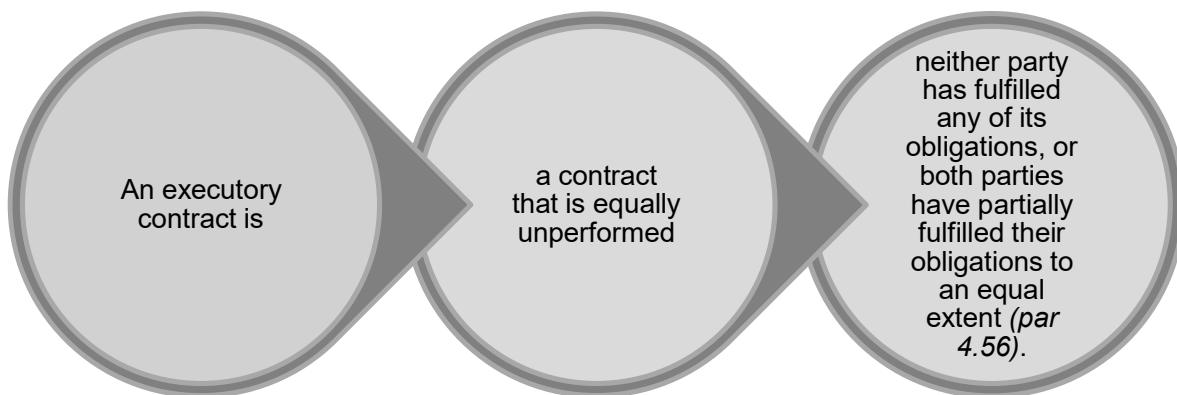
A liability does exist in respect of the claim because the claim meets criteria for a liability to exist.

### 3.5.3 Assets and liabilities

#### Unit of account

The unit of account is the right (group of rights), obligation (group of obligations) or the group of rights and obligations to which recognition criteria and measurement concepts are applied (*par 4.48*).

#### Executory contracts



Therefore, an executory contract establishes:

- a combined right and obligation to exchange economic resources;
- that are interdependent and cannot be separated and
- constitute a single asset or liability (*par 4.57*).

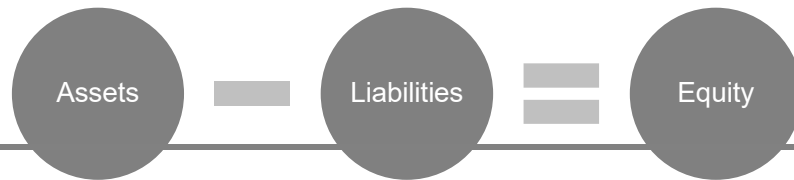
#### Substance of contractual rights and contractual obligations

To represent contractual rights and obligations faithfully, financial statements must report their substance. In some cases, the substance of such rights and obligations is clear from a contract's legal form. But, in other cases, the terms of the contract, or of a group or series of contracts, may require analysis to identify the substance of the rights and obligations (*par 4.59*).

A term has no substance if it has no financial impact on the contract and must be disregarded. Terms that have no substance could include, for example:

- terms that bind neither party; or
- rights, including options, that the holder will not have the practical ability to exercise in any circumstances (*par 4.61*)

### 3.5.4 Equity



**EQUITY** is defined as

The residual interest in the assets of the entity after deducting all its liabilities. (*par 4.63*).

Equity claims are claims that do not meet the definition of a liability and are established by contract, legislation or similar means and include:

- shares of various types issued by the entity; and
- some obligations of the entity to issue another equity claim (*par 4.64*).

Different classes of equity claims, such as ordinary shares and preference shares, may confer on their holders' different rights, for example, rights to receive some or all of the following from the entity

- dividends, if the entity decides to pay dividends to eligible holders;
- the proceeds from satisfying the equity claims, either in full on liquidation, or in part at other times; or
- other equity claims (*par 4.65*).

### 3.5.5 Income and Expenses

**INCOME** is defined as

- increases in assets, or
- decreases in liabilities,
- that result in increases in equity, other than those relating to contributions from holders of equity claims (*par 4.68*)

**EXPENSES** are defined as

- decreases in assets, or
- increases in liabilities,
- that result in decreases in equity, other than those relating to distributions to holders of equity claims (*par 4.69*)

It follows from these definitions that contributions from holders of equity claims are not income, and distributions to holders of equity claims are not expenses (*par 4.70*).

### 3.6. Recognition and Derecognition (Chapter 5)

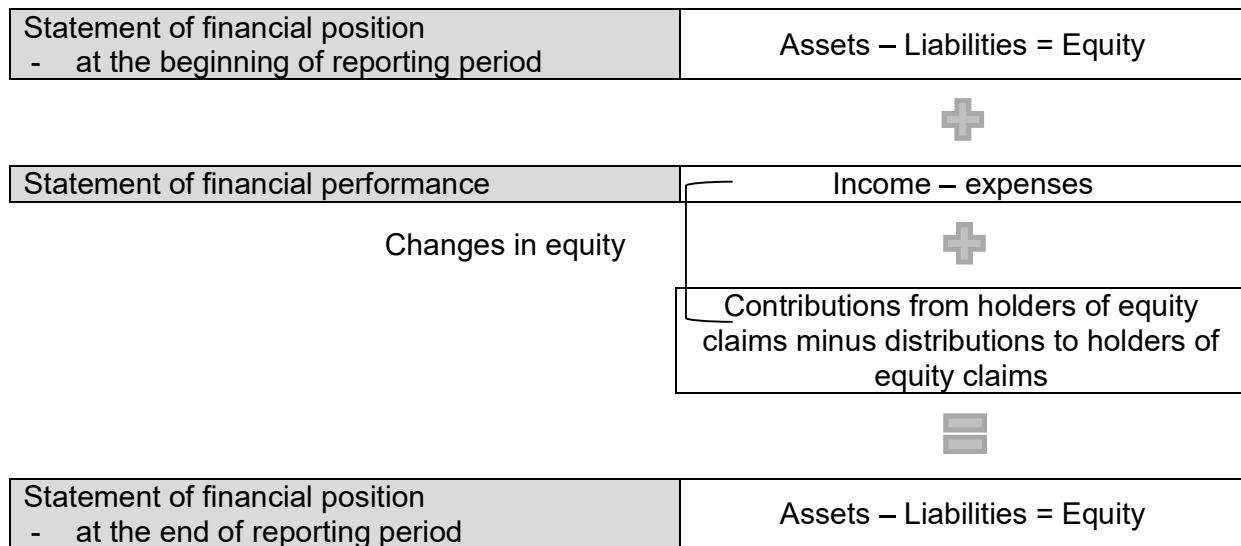
Chapter 5 of the *Conceptual Framework* discusses criteria for including assets and liabilities in financial statements (recognition) and guidance on when to remove them (derecognition).

### 3.6.1 The recognition process

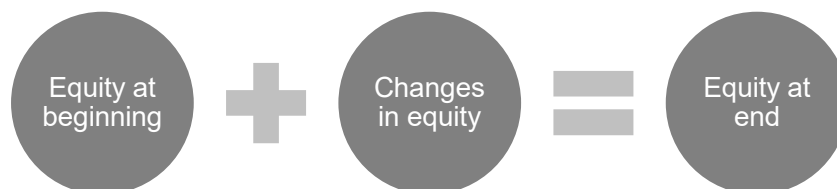
An item that **meets the definition** of one of the elements of financial statements (an asset, a liability, equity, income or expenses) must be included in the statement of financial position or the statement(s) of financial performance. The process of capturing the element for inclusion is the recognition process. Recognition involves:

- presenting the item in the statement of financial position or the statement(s) of financial performance (alone or in aggregation with other items);
- in words and by a monetary amount; and
- including that amount in one or more totals in that statement (*par 5.1*).

The following diagram illustrates how recognition links the elements of the financial statements (*par 5.4*):



Therefore;



The statements are linked because the recognition of one item (or a change in its carrying amount) requires the recognition or derecognition of one or more other items (or changes in the carrying amount of one or more other items) (*par 5.4*).

### 3.6.2 Recognition criteria

Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position. Similarly, only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance. (*par 5.6*).

However not all items that meet the definition of an element is recognised (*par 5.6*). Recognition is appropriate if it results in both:

- relevant information about assets, liabilities, equity, income and expenses and
- a faithful representation of the asset or liability and any resulting income, expenses or changes in equity,

because the aim is to provide information that is useful to users (*par 5.7*). Even if an item meeting the definition of an asset or liability is **not recognised**, an entity may need to provide information about that item in the **notes** (*par. 5.11*).

## Relevance

Recognition of a particular asset or liability and any resulting income, expenses or changes in equity may not always provide relevant information. That may be the case if, for example:

- it is uncertain whether an asset or liability exists (existence uncertainty); or
- an asset or liability exists, but the probability of an inflow or outflow of economic benefits is low (*par 5.12*)



### Existence uncertainty

An asset or liability may not meet the definition criteria because it is uncertain whether an asset or liability exists. If existence of the asset or liability is uncertain and there is a low probability of inflows or outflows of economic benefits and an exceptionally wide range of possible outcomes, it may mean that the **recognition** of an asset or liability, necessarily measured at a single amount, would **not provide relevant information**. Whether or not the asset or liability is recognised, explanatory information about the uncertainties associated with it may need to be provided in the financial statements (*par 5.14*).



### Low probability of an inflow or outflow of economic benefits

An asset or liability can exist even if the probability of an inflow or outflow of economic benefits is low (*par 5.15*).

If the probability of an inflow or outflow of economic benefits is low, the most relevant information about the asset or liability may be:

- information about the magnitude of the possible inflows or outflows;
- their possible timing;
- and the factors affecting the probability of their occurrence.

The above information is usually disclosed in the notes (*par 5.16*).

Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or liability may provide relevant information beyond the information described in paragraph 5.16 above. Whether that is the case may depend on a variety of factors (*par 5.17*).

**Example:**

- If an asset is acquired or a liability is incurred in an exchange transaction on market terms, its cost generally reflects the probability of an inflow or outflow of economic benefits. Thus, that cost may be relevant information, and is generally readily available. Furthermore, not recognising the asset or liability would result in the recognition of expenses or income at the time of the exchange, which might not be a faithful representation of the transaction.
- If an asset or liability arises from an event that is not an exchange transaction, recognition of the asset or liability typically results in recognition of income or expenses. If there is only a low probability that the asset or liability will result in an inflow or outflow of economic benefits, users of financial statements might not regard the recognition of the asset and income, or the liability and expenses, as providing relevant information.

**Faithful representation**

Whether a faithful representation can be provided may be affected by:

- the level of measurement uncertainty associated with the asset or liability or
- other factors (*par 5.18*).

**Measurement uncertainty**

For an asset or liability to be recognised, it must be measured. Often, such measures must be estimated and are therefore subject to measurement uncertainty. A high level of measurement uncertainty does not necessarily prevent such an estimate from providing useful information as the use of reasonable estimates are an essential part of preparing financial statements (*par 5.19*).

In limited circumstances where the measurement uncertainty is so high that none of the measurements would provide useful information, the asset or liability would not be recognised (*par 5.22*).

Whether or not an asset or liability is recognised, a faithful representation of the asset or liability may need to include explanatory information about the uncertainties associated with the asset or liability's:

- existence;
- measurement; or
- with its outcome (the amount or timing of any inflow or outflow of economic benefits that will ultimately result from it) (*par 5.23*).



## Other factors

Faithful representation of a recognised asset, liability, equity, income or expenses involves not only recognition of that item, but also its measurement as well as presentation and disclosure of information about it (see Chapters 6 – 7) (*par 5.24*).

Therefore, when assessing whether the recognition of an asset or liability can provide a faithful representation of the asset or liability, it is necessary to consider not merely its description and measurement in the statement of financial position, but also: (*par 5.25*)

- the presentation of resulting income, expenses and changes in equity

If an entity acquires an asset, not recognising the asset would result in recognising an expense. Then if the entity does not consume the asset immediately, the recognition of the expense provides a misleading representation that the entity's financial position has deteriorated.

- Whether related assets and liabilities are recognised (recognition inconsistency/accounting mismatch)

If assets or liabilities are not recognised, recognition may create a recognition inconsistency (accounting mismatch).

- presentation and disclosure of information about the asset or liability and resulting income, expenses and changes in equity

## EXAMPLE 2

The operations of an entity in the oil industry causes land contamination. The entity operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination caused by its operations. The entity has a record of honouring this published policy.



### REQUIRED:

Discuss, in terms of the *Conceptual Framework*, whether the entity should recognise a liability, assuming the entity has contaminated the land.

## SOLUTION 2

The question here is the following:

- Should a liability be recognized in respect of the commitment to clean up the contamination?

**STEP 1: What theory do I need?**

Basic theory from the *Conceptual Framework* regarding the definition of a liability and the recognition criteria is essential knowledge to answer the question. Therefore, provide the definition of a liability and the recognition criteria:

*A liability is defined as a*

- *present obligation of the entity*
- *to transfer an economic resource*
- *as a result of past events (par 4.26).*

*Recognition of an items that meets the definition of a liability is appropriate if it results in both:*

- *relevant information about the liability and*
- *a faithful representation of the liability*

**STEP 2: Test whether a liability exists and whether recognition is appropriate (Application)**

The conceptual framework identifies certain criteria that needs to be met for a liability to exist. Therefore, provide the criteria:

*For a liability to exist, the cost to clean up the contaminated land must meet all three of the following criteria:*

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

Discuss the criteria in terms of the question scenario:

***Does the entity have an obligation?***

*An obligation is a duty or responsibility that the entity has no practical ability to avoid (par. 4.29). The entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. Therefore, the entity has an obligation as they have a duty to incur clean up costs that they cannot practically avoid due to the constructive obligation arising from their its published policy and its customary practice of honouring this policy.*

***Is the obligation to transfer an economic resource?***

*The potential should exist for the entity to be required to transfer an economic resource to another party.*

*The obligation already exists as the entity has a constructive obligation to clean up the contaminated land and will be required to either pay cash to a third party to clean up the contamination or pay employee salaries in exchange for receiving the employees' services of cleaning up the contaminated land.*

***Is the obligation a present obligation that exists as a result of past events?***

*The entity operations cause land contamination. Due to their past operations that caused the contamination, they will have to transfer cash to pay for the cost of cleaning up the contamination.*

The obligation to clean up the contaminated land complies with the definition of a liability and therefore, the recognition criteria should be considered:

**Will recognition provide relevant information about the liability?**

Recognising a liability for the obligation to clean up the contaminated land will provide relevant information because:

- the entity's constructive obligation indicates that there is no existence uncertainty, and
- the probability of an outflow of economic resources is not low as the entity will have to pay for the land restoration and has a record of honouring its published policy.

**Will recognition provide a faithful representation of the liability?**

Recognising a liability for the obligation to clean up the contaminated land will provide a faithful representation because

- a reasonable estimate of the cost should be possible due to the entity's record of honouring its published policy; and
- if the entity does not raise a liability in the current year, it will not have a liability against which to write off the costs incurred for the restoration resulting in an accounting mismatch. The accounting mismatch may occur because the cost is written off in a different period to the event giving rise to the liability (contamination). Therefore, recognition of the liability will lead to a faithful representation.

**STEP 3: CONCLUDE**

A liability should be recognised as the obligation to clean up the contaminated land meets the definition of a liability and the recognition requirements.



**LECTURER'S COMMENT**

The question in the example asks whether a liability can be **recognised** in the financial statement.

Note that this is different from example 1 that requires the student to determine if the claim **met the definition** of a liability.

**EXAMPLE 3**

Sellalot Ltd is a leading online store that sell a wide range of retail products to customers. During the financial year ended 31 December 20.18 Sellalot Ltd acquired a warehouse for R1,5 million. Sellalot Ltd purchased the warehouse due to an increase in sales and shortage of storage facilities.



**REQUIRED:**

Motivate with reasons if the warehouse acquired should be recognised as an asset in terms of the *Conceptual Framework*.

### SOLUTION 3

#### STEP 1: What theory do I need?

Basic theory from the *Conceptual Framework* regarding the definition of an asset and the recognition criteria is essential knowledge to answer the question. Therefore, provide the definition of an asset and the recognition criteria:

*An asset is defined as a*

- *present*
- *economic resource (being a right that has the potential to produce economic benefits)*
- *controlled by the entity*
- *as a result of past events (par 4.3)*

*Recognition of the asset is appropriate if it results in both:*

- *relevant information about the asset and*
- *a faithful representation of the asset.*

#### STEP 2: Test whether an asset exists (Application)

*The Conceptual Framework identifies certain criteria that needs to be met for an asset to exist. Therefore, provide the criteria:*

*For an asset to exist, the following important aspects of the definition must be met:*

- *right*
- *potential to produce economic benefits and*
- *control*
- *as a result of past events*

#### **Right**

*An economic resource represents a right that has the potential to produce economic benefits. There is a right to use the warehouse. The right was established by the purchase agreement. Therefore, a right exists.*

#### **Potential to produce economic benefits**

*An economic resource could produce economic benefits for an entity by enabling it to store goods in the warehouse. Cash inflows are expected from the sale of the goods to customers. Therefore, the right has the potential to produce economic benefits.*

#### **Control**

*Sellalot Ltd purchased the warehouse and therefore controls the rights associated with ownership. Sellalot Ltd has the present ability to direct the use of the warehouse to store goods for future sale and prevent other parties from using the warehouse by employing security measures. Therefore, Sellalot Ltd does exercise control over this right.*

#### **Past Event**

*The past event giving rise to the asset is the purchase of the warehouse. Therefore, a past event gave rise to the economic resource controlled by Sellalot Ltd.*

The warehouse does comply with the definition of an asset and therefore, the recognition criteria need to be considered.

**Will recognition provide relevant information about the asset?**

Recognising the warehouse as an asset will provide relevant information because:

- the entity's right of ownership indicates that there is no existence uncertainty, and
- the probability of an inflow of economic benefits is not low as the additional warehouse facilities were acquired in response to the increase in market share.

**Will recognition provide a faithful representation of the asset?**

Recognising the warehouse as an asset will provide a faithful representation because:

- a reasonable estimate is possible as the warehouse was purchased for R1,5 million; and
- if an asset is not recognised in the current year, it will result in an accounting mismatch because the warehouse is not a consumable asset and recognising an expense of R1,5 million will not faithfully represent the entity's profit and equity.

**STEP 3: Conclude**

The warehouse should be recognised as an asset as it complies with both the definition of an asset and with the recognition criteria.

**EXAMPLE 4**

Sellalot Ltd is a leading online store that sell a wide range of retail products to customers. Sellalot Ltd contracted a professional cleaning company to clean the newly acquired warehouse (refer example 3) for R5 000 before they started using the facilities to store their goods. The invoice for the cleaning services rendered was paid for after 31 December 20.18 yearend.



**REQUIRED:**

Motivate with reasons if the cleaning services should be recognised as an expense in terms of the *Conceptual Framework*.

**SOLUTION 4**

**STEP 1:** What theory do I need?

Basic theory from the *Conceptual Framework* regarding the definition of an expense and the recognition criteria is essential knowledge to answer the question. Therefore, provide the definition of an expense and the recognition criteria:

*Expenses are defined as*

- decreases in assets; or
- increases in liabilities;
- that result in decreases in equity, other than those relating to distributions to holders of equity claims (par 4.69)

*The recognition of expenses occurs at the same time as initial recognition of a liability or an increase of the carrying amount of a liability or the derecognition of an asset or decrease in the carrying amount of an asset (par. 5.4(b)).*

*Recognition of a liability is appropriate if it results in both:*

- relevant information about the liability and
- a faithful representation of the liability.

**STEP 2: Test whether an expense exists (Application)**

*Discuss the definition of an expense in terms of the scenario:*

**Decrease in assets or increase in liabilities**

*The cleaning services will increase accounts payable (a liability) until payment is made after year end.*

**Decreases in equity, other than those relating to distributions to holders of equity claims**

*The increase in accounts payable will decrease equity and does not represent distributions to holders of equity.*

**Recognition criteria**

*The cleaning services will only be settled later and therefore recognition of the expense is appropriate as the initial recognition of accounts payable is appropriate as the entity has a present obligation to transfer cash as a result of obtaining the service.*

**Will recognition provide relevant information about the liability?**

*Recognising a liability for the obligation to pay for the cleaning services will provide relevant information because:*

- *the invoice received for the cleaning services indicates that there is no existence uncertainty, and*
- *the probability of an outflow of economic resources is not low as Sellalot Ltd is expected to pay for the account after year end.*

**Will recognition provide a faithful representation of the liability?**

*Recognising a liability for the obligation to pay for the cleaning services will provide a faithful representation because*

- *a reasonable estimate of the cost is possible as the agreed amount is R5 000; and*
- *if Sellalot Ltd does not raise a liability in the current year, it will not have a liability against which to recognise the payment. Therefore, recognition of the liability will lead to a faithful representation.*

**STEP 3: CONCLUDE**

An expense for the cleaning services should be recognised as the cleaning services comply with both the definition of an expense and the recognition requirements.

**3.6.3 Derecognition**

Derecognition is the **removal** of all or part of a recognised asset or liability from an entity's statement of financial position (*par 5.26*).

<b>Derecognition normally occurs</b>	
<b>For an asset</b>	<b>For a liability</b>
<ul style="list-style-type: none"> <li>• when that item no longer meets the definition of an asset</li> <li>• the entity loses control of all or part of the recognised asset (<i>par 5.26(a)</i>)</li> </ul>	<ul style="list-style-type: none"> <li>• when that item no longer meets the definition of a liability</li> <li>• when the entity no longer has a present obligation for all or part of the recognised liability (<i>par 5.26(b)</i>)</li> </ul>

<b>Derecognition aims to faithfully represent both</b>
<ul style="list-style-type: none"> <li>• any assets and liabilities retained after the transaction that led to the derecognition</li> <li>• the change in the entity's assets and liabilities as a result of that transaction (<i>par 5.27</i>)</li> </ul>

Derecognition of an asset may result from the transfer of an asset (*par 5.29*) or when a contract is modified in a way that reduces or eliminates existing rights and obligations (*par 5.33*).

### 3.7 Measurement (Chapter 6)

This chapter describes various measurement bases and discusses factors to be considered when selecting a measurement basis. Elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis.

#### 3.7.1 Measurement bases

The two measurement bases are:

- Historical cost
- Current value

The tables below illustrate the different measurement bases:

Historical cost	Basis upon which elements are measured/recognised	
	Assets	Liabilities
<p><b>Historical cost</b> measures <i>pro- vide monetary information based on the transaction price (par 6.4)</i>.</p>	<p>Recorded at the value of the costs incurred in acquiring or creating the asset, being the consideration paid plus transaction costs (<i>par 6.5</i>).</p> <p>The value of assets is reduced if they become impaired (<i>par 6.4</i>). Historical cost is updated over time, for:</p> <ul style="list-style-type: none"> <li>• depreciation or amortization;</li> <li>• payments received;</li> <li>• impairment; and</li> <li>• accrual of interest (<i>par 6.9</i>).</li> </ul>	<p>Recorded at the value of the consideration received to incur or take on the liability minus transaction costs (<i>par 6.5</i>)</p> <p>The value of liabilities is increased if they become onerous (<i>par 6.4</i>). Historical cost is updated over time, for</p> <ul style="list-style-type: none"> <li>• fulfilment of liability (example: payment or delivery of goods);</li> <li>• a liability that becomes onerous; and</li> <li>• accrual of interest (<i>par 6.8</i>).</li> </ul>

#### Current value

Current value measures provide monetary information that is updated to reflect conditions at the measurement date of assets, liabilities and related income and expenses (*par 6.10*). Current value measurement bases include: **Fair value**, **Value in use (for assets)** and **fulfillment value (for liabilities)** and **Current cost (par 6.11)**

Current value	Basis upon which elements are measured/recognised	
	Assets	Liabilities
<p><b>Fair value reflects the perspective of market participants (par 6.13)</b>.</p>	<p>Fair value is the price that would be received to sell an asset, in an orderly transaction between market participants at the measurement date (<i>par 6.12</i>).</p> <p>Fair value is not increased by the transaction costs (<i>par 6.16</i>).</p>	<p>Fair value is the price that would be paid to transfer a liability, in an orderly transaction between market participants at the measurement date (<i>par 6.12</i>).</p> <p>Fair value is not decreased by the transaction costs (<i>par 6.16</i>).</p>

Current value	Basis upon which elements are measured/recognised	
	Assets	Liabilities
<b>Fair value reflects the perspective of market participants (par 6.13). (continued)</b>	Fair value can be determined by either: <ul style="list-style-type: none"> <li>• directly observing prices in an active market; or</li> <li>• indirectly using measurement techniques reflecting the following: <ul style="list-style-type: none"> <li>- estimates of future cash flows;</li> <li>- possible variations in estimated timing and amount of future cash flows;</li> <li>- time value of money;</li> <li>- risk premium of discount to reflect inherent uncertainty;</li> <li>- liquidity; and</li> <li>- credit risk of parties (par 6.14 – 6.15).</li> </ul> </li> </ul>	
<b>Value in use and fulfilment value reflects an entity-specific perspective (par 6.19).</b>	Value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal (par 6.17).	Fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability. (par 6.17).
	Value in use is not increased by the transaction costs incurred at acquisition but include the present value of the expected transaction cost at disposal (par 6.18).	Fulfilment value is not decreased by the transaction costs incurred at acquisition, but include the present value of the expected transaction cost at fulfilment (par 6.18)
	Value in use and fulfilment value cannot be observed directly and should be determined using cash-flow-based measurement techniques, that reflect the same factors as the indirect measurement techniques as listed above for fair value (par. 6.20).	
<b>Current cost</b>	The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid plus transaction costs that would be incurred at the measurement date (par 6.21).	The current cost of a liability is the consideration that would be received for an equivalent liability minus the transaction costs that would be incurred at the measurement date (par 6.21).
	If current cost cannot be determined directly by observing prices in an active market, it must be determined indirectly (example: if prices are available only for new assets, the current cost of a used asset might need to be estimated by adjusting the current price of a new asset to reflect the current age and condition of the asset held by the entity) (par 6.22).	

### 3.7.2 Information provided by particular measurement bases

When selecting a measurement basis, it is important to consider the nature of the information that the measurement basis will produce in both the statement of financial position and the statement(s) of financial performance (par 6.23).

### 3.7.3 Factors to consider when selecting a measurement basis

Similar to recognition of an item, the factors to be considered when selecting a measurement basis are

- relevance; and
- faithful representation

because the aim is to provide information that is useful to users. The information provided should also be comparable, verifiable, timely and understandable.

#### Relevance

Relevance of information provided by a measurement basis for an asset or liability and for related income and expenses is effected by:

- Characteristics of the asset and liability
- How the asset or liability contributes to future cash flows (*par 6.49*).

The following table is a summary of these effects:

The characteristics of the asset or liability ( <i>par 6.49</i> )	How that asset or liability contributes to future cash flows ( <i>par 6.49</i> )
<p>Characteristics include:</p> <ul style="list-style-type: none"> <li>• the variability of net cash flows and</li> <li>• whether the value of the asset or liability is sensitive to market factors or other risks (<i>par 6.50</i>).</li> </ul> <p><b>Example:</b> If the value of an asset or liability is sensitive to market factors and risks, its historical costs may differ significantly from its current value. Consequently, historical cost may not provide relevant information about changes in its value if changes in its value is important to users of financial statements (<i>par 6.51</i>).</p>	<p>Economic resources produce cash flows, either:</p> <ul style="list-style-type: none"> <li>• directly; or</li> <li>• indirectly (i.e. in combination with other economic resources)</li> </ul> <p>The nature of the business activities conducted by the entity influences how economic resources are used, and consequently how cash flows are produced from assets and liabilities (<i>par 6.54</i>)</p> <p><b>Example:</b> If several economic resources are used to produce cash flow indirectly, by being used in combination to produce and market goods or services to customers, historical cost or current cost are likely to provide relevant information (example: property, plant and equipment and inventory) (<i>par 6.55</i>)</p>

#### Faithful representation

Using different measurement bases for assets and liabilities that are related in some way can create a measurement inconsistency (accounting mismatch). Financial statements that contain measurement inconsistencies may not faithfully represent some aspects of the entity's financial position and financial performance (*par 6.58*).

Measurement uncertainty arises when a measure must be estimated because it cannot be determined directly by observing prices in an active market. The level of measurement uncertainty associated with a measurement basis may affect whether information provided

by that measurement basis provides a faithful representation of an entity's financial position and financial performance. A high level of measurement uncertainty does not necessarily prevent the use of a measurement basis that provides relevant information. However, in some cases the level of measurement uncertainty is so high that information provided might not provide a sufficiently faithful representation. In such cases, it is appropriate to consider selecting a different measurement basis that would also result in relevant information (*par 6.60*).

Measurement uncertainty differs from outcome uncertainty and existence uncertainty:

- Outcome uncertainty is when there is uncertainty about the amount and timing of any inflow or outflow of economic benefits from an asset or liability,
- Existence uncertainty is when there is uncertainty whether an asset or liability exists (*par. 6.61*).

### **Enhancing qualitative characteristics and the cost constraint**

The following enhancing qualitative characteristics have implications on the selection of a measurement basis (*par 6.63*).

- comparability; using the same measurement basis for the same items every year or for a single year across many entities helps make the financial statements more comparable (*par 6.65*).
- understandability; financial statements may be less understandable if a measurement basis is changed. A change may be justified if the change results in more relevant information. The reporting entity must then provide users with explanatory information so that users may understand the effects of the change (*par 6.66*).  
Generally, the more measurement bases used, the more complex and less understandable the financial statements become resulting in less informative information. However, using more measurement bases may be necessary to provide useful information (*par 6.67*); and
- verifiability; if a measurement base can be independently corroborated either directly (example: observing prices), or indirectly (example: checking inputs to a model) then it is verifiable. If a measurement base cannot be verified, then the reporting entity must provide users with explanatory information so that users may understand how the measure was determined. (*par 6.68*).

#### **3.7.4 Measurement of equity**

The total carrying amount of equity (total equity) is not measured directly. It equals the total of the carrying amounts of all recognised assets less the total of the carrying amounts of all recognised liabilities (*par 6.87*).

Because general purpose financial statements are not designed to show an entity's value, total equity will not generally equal:

- the aggregate market value of equity claims on the entity;
- the amount that could be raised by selling the entity as a whole on a going concern basis; or
- the amount that could be raised by selling all of the entity's assets and settling all of its liabilities (*par 6.88*).

## 3.8 Presentation and disclosure (Chapter 7)

Chapter 7 of the *Conceptual Framework* includes concepts on presentation and disclosure and guidance on including income and expenses in the statement of profit or loss and other comprehensive income.

### 3.8.1 Presentation and disclosure as communication tools

Information about assets, liabilities, equity, income and expenses is communicated through presentation and disclosure in the financial statements of a reporting entity (*par 7.1*).

Effective communication of information in financial statements makes that information more relevant and contributes to a faithful representation of an entity's assets, liabilities, equity, income and expenses. It also enhances the understandability and comparability of information in financial statements (*par 7.2*).

### 3.8.2 Presentation and disclosure objectives and principles

In order to have effective communication of information, presentation and disclosure requirements must be developed to ensure a balance between:

- flexibility to determine relevant information that faithfully represents the entity's assets, liabilities, income, expenses and equity and
- requiring comparable information both between periods for a single entity and for a single period across reporting entities (*par 7.4*).

The following principles must be considered for effective communication:

- entity-specific information is more useful than standardized descriptions (boilerplate) and
- unnecessary duplication of information across the financial statements make the financial statements less understandable (*par 7.6*).

### 3.8.3 Classification

Classification means arranging the elements of the financial statements based on common characteristics for presentation and disclosure purposes; and can be based on:

- the nature of the item,
- its role (or function) within the business activities conducted by the entity, and
- how it is measured (*par 7.7*).

Classifying dissimilar elements together can obscure relevant information, reduce understandability and comparability and may not provide a faithful representation of what it purports to represent (*par 7.8*).

### Classification of assets and liabilities

Classification is applied to the unit of account selected for an asset or liability. However, it may sometimes be appropriate to separate an asset or liability into components that have different characteristics and to classify those components separately to enhance the usefulness of the resulting financial information. (*par 7.9*).