Accounting (Basics) - Lecture 13

INTERNATIONAL FINANCIAL REPORTING STANDARDS – CONCEPTUAL FRAMEWORK.

Content

- International Financial Reporting Standards
- Conceptual framework of IFRS

International Accounting Standards Board

- The **International Accounting Standards Board** (**IASB**) is the independent, accounting standard-setting body of the IFRS Foundation.
- The IASB was founded on April 1, 2001, as the successor to the International Accounting Standards Committee (IASC).
- It is responsible for developing International Financial Reporting Standards (IFRS), previously known as International Accounting Standards (IAS) and promoting the use and application of these standards.

IFRS

- The **International Financial Reporting Standards**, usually called the **IFRS Standards**, are standards issued by the IFRS Foundation and the International Accounting Standards Board (IASB) to provide a common global language for business affairs so that company accounts are understandable and comparable across international boundaries.
- They are a consequence of growing international shareholding and trade and are particularly important for companies that have dealings in several countries.
- They are progressively replacing many different national accounting standards.

IFRS

- They are the rules to be followed by accountants to maintain books of accounts which are comparable, understandable, reliable and relevant as per the users internal or external.
- IFRS, with the exception of *IAS 29 Financial Reporting in Hyperinflationary Economies* and *IFRIC 7 Applying the Restatement Approach under IAS 29*, are authorized in terms of the historical cost paradigm.
- IAS 29 and IFRIC 7 are authorized in terms of the units of constant purchasing power paradigm.

IFRS

- IFRS began as an attempt to harmonize accounting across the European Union but the value of harmonization quickly made the concept attractive around the world.
- However, it has been debated whether or not de facto harmonization has occurred.
- Standards that were issued by IASC (the predecessor of IASB) are still within use today and go by the name **International Accounting Standards** (IAS), while standards issued by IASB are called IFRS.

IFRS

- IAS were issued between 1973 and 2001 by the Board of the International Accounting Standards Committee (IASC).
- On 1 April 2001, the new International Accounting Standards Board (IASB) took over from the IASC the responsibility for setting International Accounting Standards.
- During its first meeting the new Board adopted existing IAS and Standing Interpretations Committee standards (SICs).
- The IASB has continued to develop standards calling the new standards "International Financial Reporting Standards".

IFRS

- Criticisms of IFRS are
  - (1) that they are not being adopted in the US
  - (2) a number of criticisms from France and
  - (3) that *IAS 29 Financial Reporting in Hyperinflationary Economies* had no positive effect at all during 6 years in Zimbabwe's hyperinflationary economy.

  - The IASB offered responses to the first two criticisms, but has offered no response to the last criticism while IAS 29 was as of March 2014 being implemented in its original ineffective form in Venezuela and Belarus.

Regulation – IASB (nature, objectives)

- The International Accounting Standards Board (IASB) was established in 2001 as part of the International Accounting Standards Committee (IASC) Foundation.
- The **objectives** of the IASC Foundation and of the IASB are:
  a) **to develop a single set** of high quality, understandable and enforceable **global accounting standards** that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions;

Regulation – IASB (nature, objectives)

b) **to promote the use** and rigorous application of those standards;
c) **to take account of the special needs of SM entities** and emerging economies; and
d) **to bring about convergence** of national accounting standards and IAS and IFRS to high quality solutions.

Regulation – IASB (functions)

- **IASB is the standard-setting body of the IASC Foundation** - it is responsible for approving **IFRS** (including Interpretations) and related documents, such as the **Framework** for the Preparation and Presentation of Financial Statements, exposure drafts and discussion documents.
- The IASB achieves its objectives primarily by **developing and publishing IFRS** and promoting the use of those standards in **general purpose financial statements** and other financial reporting.

Regulation – IASB (functions)

- IAS and related Interpretations, which were adopted before IFRS were developed, remain applicable with the same authority as IFRS, unless and until they are amended or withdrawn by the IASB.

Regulation - IFRS

- **IFRS set out recognition, measurement, presentation and disclosure requirements dealing with transactions and other events and conditions that are important in general purpose financial statements.**
- IFRS are based on the Framework.
- The objective of the Framework is to facilitate the consistent and logical formulation of IFRS.
- It also provides a basis for the use of judgment in resolving accounting issues.

Regulation - IFRS

- IFRS are designed to apply to the general purpose financial statements and other financial reporting of **all profit-oriented entities**.
- The objective of financial statements is to provide information about the financial position, performance and cash flows of an entity that is useful to those users in making economic decisions.

Regulation - IFRS vs. GAAP

- Goals of FASB and IASB - the highest relevance, representational faithfulness, transparency and comparability of accounting information =>
- **Memorandum of understanding or Norwalk Agreement (2002)** and removal of obligation of US GAAP reconciliation (2007) – "Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to US GAAP"
- General comparison of US GAAP and IAS/IFRS:

US GAAP	IFRS
• rules-based • procedure-oriented	• principles-based • objective-oriented

IFRS Assets

- IFRS **guidance for assets** recognizes as assets:
    a) The future economic benefit of an asset is its potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. Those cash flows may come from using the asset or from disposing of it.
    b) Many assets, for example property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset. Some assets are intangible.

IFRS Assets

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

IFRS liabilities

- IFRS **guidance for liabilities** recognizes as liabilities:
  a) An essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way. The obligation may be either a legal obligation or a constructive obligation:
     i. A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement.

IFRS liabilities

ii. A constructive obligation is an obligation that derives from an entity's actions when by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept particular responsibilities, and, as a result, the entity has created a valid expectation on the part of those other parties that it will discharge (fulfill) those responsibilities.

IFRS liabilities

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

IFRS Equity

- IFRS **guidance for equity** recognizes as equity:
  a) Equity is the residual of recognized assets minus recognized liabilities.
  b) It may be subclassified in the statement of financial position. For example, in a corporate entity, subclassifications may include funds contributed by shareholders, retained earnings and gains or losses recognized directly in equity.

Performance

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

Performance

- IFRS defines **income and expenses** as follows:
  a) **Income** is increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity investors. The definition of income encompasses both revenue and gains:

Performance

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

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

Performance

b) **Expenses** are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity investors. The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity.

Performance

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

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

Recognition and measurement of assets, liabilities, income and expenses. Accrual basis

- Recognition is the process of incorporating in the financial statements an item that meets the definition of an asset, liability, income or expense and satisfies the following criteria:
  a) it is **probable** that any future economic benefit associated with the item will flow to or from the entity
  b) the item has a cost or value that can be **measured reliably**

Recognition and measurement of assets, liabilities, income and expenses. Accrual basis

- **Measurement is the process of determining the monetary amounts at which an entity measures assets, liabilities, income and expenses in its financial statements**. Measurement involves the selection of a basis of measurement. Two common measurement bases are:
  a) **Historical cost**:
     i. for assets - it is the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire the asset at the time of its acquisition.

Recognition and measurement of assets, liabilities, income and expenses. Accrual basis

ii. for liabilities - it is the amount of proceeds of cash or cash equivalents received or the fair value of non-cash assets received in exchange for the obligation at the time the obligation is incurred, or in some circumstances (for example, income tax) the amounts of cash or cash equivalents expected to be paid to settle the liability in the normal course of business.

Amortized historical cost is the historical cost of an asset or liability plus or minus that portion of its historical cost previously recognized as expense or income.

Recognition and measurement of assets, liabilities, income and expenses. Accrual basis

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

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

Recognition in financial statements

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

Recognition in financial statements

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

Recognition in financial statements

- An entity **shall recognize a liability in the statement of financial position when**:
  a) the entity has an obligation at the end of the reporting period as a result of a past event,
  b) it is probable that the entity will be required to transfer resources embodying economic benefits in settlement, and
  c) the settlement amount can be measured reliably.

Recognition in financial statements

- A **contingent liability** is either **a possible but uncertain obligation** or **a present obligation that is not recognized** because it fails to meet one or both of recognition conditions.
- The **recognition of income results directly from the recognition and measurement of assets and liabilities**.
- An entity shall recognize income in the statement of comprehensive income when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

Recognition in financial statements

- The **recognition of expenses results directly from the recognition and measurement of assets and liabilities**. An entity shall recognize expenses in the statement of comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.
- **Total comprehensive income is the arithmetical difference between income and expenses**. It is not a separate element of financial statements, and a separate recognition principle is not needed for it.

Recognition in financial statements

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

Initial and subsequent measurement in financial statements

- At **initial recognition** an entity shall measure assets and liabilities at **historical cost**.
- During **subsequent measurement** it is necessary to distinguish between **financial and non-financial assets and liabilities**. Basic **financial assets and basic financial liabilities** are subsequently measured at **amortized cost less impairment**.

Initial and subsequent measurement in financial statements

- Most **non-financial assets that an entity initially recognized at historical cost** are subsequently measured on other measurement bases. For example:
  a) An entity measures property, plant and equipment at the lower of depreciated cost and recoverable amount.
  b) An entity measures inventories at the lower of cost and selling price less costs to complete and sell.
  c) An entity recognizes an impairment loss relating to non-financial assets that are in use or held for sale.

Initial and subsequent measurement in financial statements. Offsetting

- Measurement of assets at those lower amounts is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.
- Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the reporting date.
- An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by IFRS.