CHAPTER 2
THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

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OVERVIEW

The IASB's Conceptual Framework belongs to the family of conceptual frameworks for financial reporting that have been developed by accounting standard-setters in a number of countries where accounting standard-setting is

carried out by a private sector body. On one level, such conceptual frameworks may be considered attempts to assemble a body of accounting theory (or interrelated concepts) as a guide to standard-setting, so that standards are (as far as possible) formulated on a consistent basis and not in an *ad hoc* manner. On another but complementary level, they may be thought of as devices to confer legitimacy and authority on a private sector standard-setter that lacks the legal authority of a public body. The IASC, as a private sector standard-setter, shared these reasons for developing a conceptual framework.

Conceptual frameworks developed by accounting standard-setters are essentially based on identification of "good practice" from which principles are derived inductively. The criteria for identifying "good practice" are related to the assumed objectives of financial reporting. At the same time, attention is paid to conceptual coherence, and the development process typically involves "conceptual tidying up." Conceptual frameworks may be written in a prescriptive style or a descriptive style, or a mixture of the two. Whatever the style, they are essentially *normative,* since they seek to provide a set of principles as a guide to setting and interpreting accounting standards. Such guidance, however, does not necessarily preclude a standard being issued that, for compelling pragmatic reasons, departs from a principle set out in the applicable conceptual framework.

The IASB's Conceptual Framework is written in a descriptive style (in fact, it is IASB policy to use the word "shall" only in standards) and seeks to avoid being excessively prescriptive. A principal reason for this is that it needs to have broad international applicability. In the final paragraph of the Framework, the then IASC stated:

> This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time [1989], it is not the intention of the Board of IASC to prescribe a particular model other than in exceptional circumstances, such as . . . a hyperinflationary economy.

In common with other conceptual frameworks, notably the FASB's set of Statements of Financial Accounting Concepts, the IASB's Conceptual Framework covers the following topics in chapters as follows:

1. *Objective of financial general purpose financial reporting*. The Framework takes the position that, because investors are providers of risk capital to an entity, financial statements that meet existing and potential investors' needs will also meet most of the needs of other users that financial statements can satisfy. On that basis, the objective of financial statements is to provide information about the financial position, performance, and changes in financial position of an entity that is useful to a wide range of users in making economic decisions, including assessment of the stewardship or accountability of management. The Framework states as "underlying assumptions" that, in order to meet their objectives, financial statements are prepared on the accrual basis of accounting and (normally) on the "going concern" basis.
2. *The reporting entity*: This chapter has not yet been included.

3. *Qualitative characteristics of financial statement information*. The Conceptual Framework cites two main qualitative characteristics: *relevance* and *faithful representation*. Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. Materiality is mentioned as an aspect of relevance. IAS 1, "Presentation of Financial Statements," mentions "fair presentation" rather than "faithful representation" as a requirement (see below).
4. This chapter contains the remaining text of the previous Framework and states the underlying assumption of (general purpose) financial statements as that of a "going concern." Following are these sections of the Framework:
   (a) *Elements of financial statements*. The Framework relates the elements to the measurement of financial position and performance. As elements of financial position, it provides definitions of assets, liabilities, and equity; and as elements of performance, it defines income (including revenue and gains) and expenses (including losses). The definitions given in the section on elements, and especially those of assets and liabilities, are the core of the Framework as a prescriptive basis for standard-setting.
   (b) *Principles for recognition of the elements*. The Framework states that recognition is the process of recording in the financial statements (subject to materiality) an item that meets the definition of an element and satisfies the two criteria for recognition, namely, (a) it is *probable* that any future economic benefit associated with the item will flow to or from the entity and (b) the item has a cost or value that can be measured with reliability. Assessments of the degree of probability of the flow of future economic benefits "are made when the financial statements are prepared."
   (c) *Bases for measurement of the elements*. Unlike the section in which the elements of financial statements are defined, the treatment of measurement in the IASC's Framework avoids being prescriptive. It cites a number of different measurement bases and notes that the basis most commonly adopted is historical cost, usually combined with other bases.

The Framework also covers another topic, which is not necessarily dealt with specifically in other conceptual frameworks:

(d) *Concepts of capital and capital maintenance*. The treatment of capital maintenance in the Framework also avoids being prescriptive. It distinguishes between (a) *financial* capital maintenance, in two forms, nominal (i.e., monetary units) or real (units of constant purchasing power) and (b) *physical* capital maintenance or operating capability. It states that the physical capital maintenance concept requires the use of a particular measurement basis, namely current cost, whereas neither form of the financial capital maintenance concept requires any particular measurement basis. It also states the implications of each concept of capital maintenance for profit measurement.

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BACKGROUND

The origins of the Framework go back to 1982, when the then IASC initiated a limited study on the objectives of financial statements. The IASC stated at that time, however, that it did not intend to prepare an "international conceptual framework." The FASB had already issued in 1978 its SFAC 1, "Objectives of Financial Reporting by Business Enterprises," and in 1980 its SFACs 2 and 3 on "Qualitative Characteristics" and "Elements." In 1982 — 1984, the FASB's Conceptual Framework project was encountering some difficulties in dealing with issues of recognition and measurement.

In 1984, the then IASC decided to revise IAS 1, "Disclosure of Accounting Policies," published in 1974, and it was also decided to merge the objectives project with this revision. In 1984 and 1985, new projects were started covering liabilities, equity and assets, and expenses. The decision to merge these into a Framework project occurred in November 1986, and the proposed revision of IAS 1 was deferred. The Framework was intended to be separate from the IASs and to avoid binding the IASC to particular accounting treatments in IASs. It was approved and issued in April 1989. Work is in progress on a joint IASB-FASB project to develop a common Conceptual Framework of which two chapters, as summarized above, have been completed.

The status of the Framework vis-à-vis IASB GAAP may be compared with that of the FASB's SFACs vis-à-vis U.S. GAAP, as follows. As noted above, the IASC did not intend the Framework to be binding on it in its capacity as a standard-setter, just as the SFACs are not binding on the FASB in its standard-setting capacity. However, the Framework has been quite influential in the development of IASs and IFRSs and in major revisions. For example, its definitions (and especially those of assets and liabilities) were highly influential in the preparation of IFRS 3, "Business Combinations"; IAS 37, "Provisions, Contingent Liabilities and Contingent Assets"; IAS 38, "Intangible Assets"; and IAS 39, "Financial Instruments: Recognition and Measurement."

The Framework is not an IAS or IFRS and does not override any specific IAS or IFRS; in case of conflict between it and an IAS, the requirements of the latter prevail. *One may, however, consider the Framework as embodying IASB GAAP in respect of issues that are not dealt with in any IAS.* For example, in the case of topics that have not yet been the subject of an IAS or IFRS, the purpose of the Framework is to assist preparers in dealing with such topics. Moreover, the IASB will be guided by the Framework in the development of future IFRSs and in reviewing existing ones, so that the number of cases of conflict between the Framework and IASs or IFRSs is likely to diminish over time. The Framework itself will be subject to revision in light of experience.

The relationship between the Framework and IAS 1, "Presentation of Financial Statements," is worthy of comment in the context of the comparison of IASB GAAP with U.S. GAAP. As noted above, originally the start of work on what became the Framework was linked to the revision of IAS 1. This revision was then deferred and not completed until 1997. The revised IAS 1 is a major standard that supersedes the former IASs 1, 5, and 13 (see Chapter 4). Although the Framework does not have the status of a standard, it and IAS 1 (revised) may

to some extent be considered as complementary. The Framework itself does not conflict with U.S. GAAP in any important respect, but IAS 1 does. Its paragraphs 16–24 contain a provision to the effect that a specific requirement of an IAS may *need* to be departed from "in extremely rare circumstances . . . when the treatment required by the standard is clearly inappropriate and thus a fair presentation cannot be achieved either by applying the standard or through additional disclosure alone." This is the so-called "override," which is quite alien to U.S. GAAP in practice, if not (according to Rule 203 of the AICPA Code of Ethics) in theory. The override is *mandatory* if the circumstances require it.

While the override represents a major difference between IASB GAAP and U.S. GAAP in principle, the restrictions placed on its use by IAS 1 suggest that there should not be many cases of it in practice.

REVISION AND REPLACEMENT OF THE FRAMEWORK BY THE CONCEPTUAL FRAMEWORK

The IASB and FASB are jointly developing the common Conceptual Framework mentioned above as part of the process of convergence between the two sets of GAAP. This project is divided into eight phases, A to H, as follows:

(A) Objectives and qualitative characteristics
(B) Elements, recognition, and measurement
(C) Measurement
(D) Reporting entity
(E) Presentation and disclosure
(F) Purpose and status
(G) Application to not-for-profit entities
(H) Finalization

Progress is slow. The Conceptual Framework, as published in the IFRS compendium for 2014, which is relevant until further notice, is obviously a partially revised, indeed hybrid, document.

A table of concordance between this (hopefully, temporary) version and the original 1989 Framework is given as follows. In this chapter we use the new reference details throughout.

Table of Concordance

This table shows how the contents of the *Framework* (1989) and the *Conceptual Framework* (2010) correspond.

Framework (1989) paragraphs	*Conceptual Framework* 2010 paragraphs
Preface and introduction paragraphs 1–5	Introduction
6–21	Superseded by Chapter 1
22	Not carried forward
23	4.1
24–46	Superseded by Chapter 3
47–110	Chapter 4

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Framework (1989) paragraphs	*Conceptual Framework* 2010 paragraphs
47, 48	4.2, 4.3
49–52	4.4–4.7
53–59	4.8–4.14
60–64	4.15–4.19
65–68	4.20–4.23
69–73	4.24–4.28
74–77	4.29–4.32
78–80	4.33–4.35
81	4.36
82–84	4.37–4.39
85	4.40
86–88	4.41–4.43
89, 90	4.44, 4.45
91	4.46
92, 93	4.47, 4.48
94–98	4.49–4.53
99–101	4.54–4.56
102, 103	4.57, 4.58
104–110	4.59–4.65

Purpose and Status

The Framework does not have the status of an IAS, does not override any specific IAS, and in case of conflict between the Framework and an IAS, the latter prevails. The purpose of the Framework is to:

- Assist the Board in the development of future IASs and in its review of existing IASs;
- Help the Board to promote harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IASs;
- Assist national standard-setting bodies in developing national standards;
- Aid preparers of financial statements in applying IASs and in dealing with topics that have yet to form the subject of an IAS;
- Assist auditors in forming an opinion as to whether financial statements conform with IASs;
- Help users of financial statements to interpret the information contained in financial statements prepared in conformity with IASs;
- Provide those who are interested in the work of the IASC with information about its approach to the formulation of accounting standards.

In the Basis of Conclusions to the (new) Conceptual Framework, the IASB states that the Conceptual Framework "establishes an objective of financial reporting and not just of financial statements," unlike the original Framework that "dealt with financial statements only."

Scope

The scope of the Framework deals with the:

- Objective of financial reporting;
- Qualitative characteristics that determine the usefulness of financial statement information;
- Definition, recognition, and measurement of financial statement elements; and
- Concepts of capital and capital maintenance.

CHAPTER 1: THE OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

In the new Chapter 1, "The Objective of General Purpose Financial Reporting," the determined use of the singular in the title is notable. The formal statement (par. OB2) is that the objective of general purpose financial reporting (GPFR) is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. These decisions involve buying, selling, or holding equity and debt instruments, and providing or settling loans and other forms of credit.

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These specified users require information to help them assess the prospects for future net cash flows to the entity. This, in turn, requires information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management (broadly defined) have discharged their duties to use the entity's resources (pars OB 3-4).

More clearly than in its 1989 document, the IASB spells out the purposes/users, which are *not* included by the above (pars. OB 5-10). The "primary users" of GPFRs are those "existing and potential investors, lenders and other creditors" who cannot force reporting entities to provide information beyond what is revealed in the GPFRs. However, GPFRs will need to be supplemented from other sources, for example, relating to economic and political developments broadly considered. It is explicitly stated that GPFRs are not designed to show the value of the reporting entity; rather, their purpose is to provide relevant information to help others determine the reporting entity's value. An even more explicit exclusion is in paragraph OB 10.

Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find GPFRs useful. However, those reports are not primarily directed to these other groups.

OBSERVATION: This last point is particularly significant, as there has been much criticism from regulators and politicians in recent years (in both Europe and the United States, and against both the IASB and FASB) that published GPFRs have failed regulators, in general, and banking regulators, in particular. This is in one sense factually correct, but the fault lies entirely with the regulators for misusing, perhaps simply not being professionally competent enough to understand, the information contained in the GPFRs.

The remaining part of Chapter 1, pars. OB12-OB21, consists of a conventional summary of the ways of providing relevant information. Information about economic resources and claims is provided in a balance sheet/statement of financial position, allowing a focus on liquidity, solvency, and financing. Information about changes in economic resources can focus on an entity's own financial/economic operating performance, through an income statement reflecting accrual accounting, and on external changes, for example, the raising of new external finance by debt or equity. Further, information about cash movements is very important, via a statement of cash flows.

CHAPTER 2: THE REPORTING ENTITY

An exposure draft of this chapter, ED/2010/2, *The Conceptual Framework for Financial Reporting—The Reporting Entity,* was published in March 2010, but it has not been finalized (see below).

CHAPTER 3: QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

Chapter 3, "Qualitative Characteristics of Useful Financial Information," of the Conceptual Framework, finalized in 2010, logically follows the (currently non-existent) Chapter 2, which will discuss the definition of, and, in particular, the boundaries of, the "Reporting Entity." Chapter 3 covers similar ground to pars. 24–46 of the 1989 Framework, but there are several significant changes. These changes have caused much discussion, debate, and criticism during the long gestation period of this material. The most significant changes are of omission: the concepts, or at least the words, of reliability and providence have both disappeared. Reliability is in effect replaced by "faithful representation," which is upgraded in importance, as discussed below.

Two "fundamental" qualitative characteristics are presented: relevance and faithful representation (pars. QC5-16).

Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it, or are already aware of it from other sources. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both.

Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information has confirmatory value if it provides feedback about (either confirms or changes) previous evaluations.

The Board notes, regarding materiality, that it is an entity-specific concept, and no proposed "qualitative threshold" would be rational. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

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The Board introduces faithful representation by noting that financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete, neutral,* and *free from error*. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximize those qualities to the extent possible. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, de-emphasized or otherwise manipulated to increase the probability that financial information will be received favorably by users.

Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon and the process used to produce the reported information has been selected and applied with no errors. In this context, free from error does not mean perfectly accurate in all respects.

In its "Basis for Conclusions" document issued at the same time as the revised Chapter 3, the IASB discussed and defends the changes made as compared with 1989. Previously, representational faithfulness, verifiability, and neutrality were aspects of (i.e., subservient to) reliability. Verbally, reliability and representational faithfulness have firstly been reversed, and then reliability has been transposed into verifiability (discussed below). The proposition, never quite clearly stated, seems to be that if "information is complete, neutral and free from error" (see above characteristics of faithful representation), then it must automatically be reliable (in the general sense that it "can be depended on" in the words of 1989). Therefore reliability is unnecessary as a separate notion. The proposition seems defensible.

"Substance over form" similarly disappears as being redundant, given faithful representation. Prudence disappears, as being inconsistent with neutrality.

OBSERVATION: It is difficult to disagree with the analytical logic behind all this. But some long-cherished beliefs in some quarters are being ruthlessly assaulted. We would suggest that the real issue is not the dropping of concepts or words. Rather, it is the continued emphasis on external, independent, suppliers of finance to entities, rather than more closely connected sources of finance such as family or banks. The full implications of Chapter 1 of the revised Conceptual Framework, and what it does *not* say, is discussed in Chapter 4.

The Board sums up the implications in practice, as follows (par. QC18):

> The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the effects of

> enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative, characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

The remaining paragraphs of Chapter 3 discuss several sub-characteristics, called "enhancing qualitative characteristics" that enhance the usefulness of information that is relevant and faithfully represented. Note that they cannot, by themselves, make information useful if it is not already properly regarded as relevant and faithfully represented. These are comparability, verifiability, timeliness, and understandability.

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item, as a comparison requires at least two items.

Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

Comparability is not uniformity. For information to be comparable, similar items must appear similar and different items must appear different. Comparability of financial information is not enhanced by making dissimilar items appear similar any more than it is enhanced by making similar items appear different.

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.

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

Classifying characteristics and presenting information clearly and concisely makes it *understandable*. Some phenomena are inherently complex and cannot be made easily understandable. Excluding this information from financial reports might make the information easier to understand; however, the information would be incomplete and, therefore, potentially misleading.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information

regularly. At times, even well-informed, diligent users may need to seek the aid of an adviser to understand complex economic phenomena.

Finally in this section, the Board notes that cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

Because of the inherent subjectivity, different individuals' assessments of the costs and benefits of reporting particular items of financial information will vary. Therefore, the Board seeks to consider costs and benefits in relation to financial reporting generally, and not solely in relation to individual reporting entities. This does not indicate that assessments of costs and benefits always justify the same reporting requirements for all entities. Differences may be appropriate, for example, because of different sizes of entities, different ways of raising capital (publicly or privately), or different users' needs.

CHAPTER 4: THE REMAINING TEXT

The remaining text of the Conceptual Framework (2010) consists of unaltered material from 1989. Paragraph 4.1 explains the concept of going concern, transposed from an earlier position in 1989.

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

The whole of the remainder follows the 1989 version exactly, in content and in sequence.

THE ELEMENTS OF FINANCIAL STATEMENTS

The section of the Framework concerning the elements of financial statements (pars. 4.2–4.35) consists essentially of definitions of the elements of financial statements as identified by the Framework.

OBSERVATION: As noted in the Overview, the definitions given in this section, and especially those of assets and liabilities, are the core of the Framework as a prescriptive basis for standard-setting. The section on Recognition of Elements (pars. 4.37–4.53, see below) reinforces this core. In particular:

1. The Framework defines income and expenses in terms of increases and decreases in economic benefits that are equated with changes in assets and liabilities;
2. The latter are defined in terms of "resources controlled" and "present obligations" to exclude some of the types of items that have been previously recognized as assets or liabilities (accruals and deferrals) in the name of "matching" expenses and revenues; and
3. The effect of these tighter definitions, together with those of the recognition criteria set out in the section on recognition, can be seen particu-

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larly in the implications of the definition of a liability for the recognition of provisions (see Chapters 8 and 29 on IFRS 3 and IAS 37), and in the implications of the definition of an asset for the recognition of intangible items (see Chapters 8 and 22 on IFRS 3 and IAS 38).

There is an overlap between definitions and recognition criteria, since satisfying the definition of an element is the principal criterion for recognition. The Framework, however, seeks to distinguish definition issues from recognition issues as far as possible.

The Framework relates the elements of financial statements to the measurement of financial position and performance. As elements of financial position (in the balance sheet), it provides definitions of assets, liabilities, and equity; and as elements of performance (in the income statement), it defines income, including revenue and gains, and expenses, including losses. As for the statement of changes in financial position, this "usually reflects income statement elements and changes in balance sheet elements," and so the Framework does not identify any elements associated uniquely with this statement (par. 4.2).

Financial Position

The elements considered to be "directly related to the measurement of financial position" are assets, liabilities, and equity, which are defined as follows (par. 4.4):

1. An asset is a resource (a) controlled by the enterprise, (b) as a result of past events, and (c) from which future economic benefits are expected to flow to the enterprise. Recognition as an asset thus requires that the three components of the definition, (a), (b), and (c), be satisfied.
2. A liability is (a) a present obligation of the enterprise, (b) arising out of past events, (c) the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. Recognition as a liability thus requires that the three components of the definition, (a), (b), and (c), be satisfied.
3. Equity is defined as the residual interest in the assets of the enterprise after deducting all its liabilities.

OBSERVATION: Financial position comprises a number of attributes, including liquidity, solvency, leverage, asset structure, reserves available to cover dividends, and so forth. While each of these attributes may be measured, it is not clear what is meant by "measurement" of financial position as such, which is the terminology used in paragraph 4.4. A term such as "evaluation of financial position" would be more usual.

Merely satisfying the above definitions does not entail recognition, as the recognition criteria in pars. 4.37–4.53 must also be satisfied, and also the principle of "substance over form" must be respected. For example, this principle requires fixed assets held under finance leases to be recognized by the lessee as fixed assets (with corresponding leasing liabilities), while the lessor recognizes a financial asset (pars. 4.5–4.6).

Balance sheets drawn up in accordance with "current" IASs may include items the treatment of which does not satisfy the *above* definitions, but the definitions will underlie "future" reviews of existing standards and the formulation of new ones (par. 4.7). As noted above, the IASC acted accordingly, and it would now be unusual to find an item whose treatment according to a current IAS would conflict with the definitions.

Assets

The "future economic benefit embodied in an asset" is defined as "the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise," including "a capability to reduce cash outflows." In case that definition should leave the status of cash itself as an asset unclear, it is stated that cash satisfies this definition, because it "renders a service to the enterprise because of its command over other resources." Assets embody future economic benefits that may flow to the enterprise by having one or more of the following capabilities: (a) being exchanged for other assets; (b) being used to settle a liability; or (c) being distributed to the enterprise's owners (three capabilities that cash conspicuously possesses); as well as that of being used singly or in combination with other assets in the production of goods and services to be sold by the enterprise (pars. 4.8–4.10).

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Neither having physical form, nor being the object of a right of ownership, is an essential attribute of an asset. Intangible items such as patents and copyrights may satisfy the definition of an asset, as may a fixed asset held under a finance lease (by virtue of which it is a resource controlled though not owned by, and from which future benefits are expected to flow to, the entity). Moreover, knowledge obtained from development activity may meet the definition of an asset (capitalized development costs) even though neither physical form nor legal ownership is involved, provided there is *de facto* control such that, by keeping the knowledge secret, the enterprise controls the benefits that are expected to flow from it (pars. 4.11–4.12).

Assets may result from various types of past transactions and other past events. Normally, these are purchase transactions and the events associated with production; but they may include donation (for example, by way of a government grant) or discovery (as in the case of mineral deposits). Expected future transactions or events do not give rise to assets; for example, a binding contract by an enterprise to purchase inventory does not cause the inventory in question to meet the definition of an asset of that enterprise until the purchase transaction that fulfils the contract has occurred. While expenditure is a common way to acquire or generate an asset, expenditure undertaken with a view to generating future economic benefits may fail to result in an asset, for example, if the intended economic benefits cannot be expected or are not controlled by the entity (pars. 4.13–4.14).

Liabilities

An essential characteristic of (or necessary condition for) a liability is that the entity should have a "present obligation." An obligation is "a duty or responsi-

bility to act or perform in a certain way." The duty or responsibility may arise from the law, for example, the law of contract; or it may arise from normal business practice, which leads to legitimate expectations that the entity will act or perform in a certain way (that is, a constructive obligation). An example of the latter is a constructive obligation to extend the benefits of a warranty for some period beyond the contractual warranty period, because this is an established practice (par. 4.15).

A present obligation (in the relevant sense) is not the same as a future commitment. An entity may have a commitment to purchase an asset in the future at an agreed price; however, this does not entail a net outflow of resources. The commitment does not give rise to a liability, which arises only when the purchase has actually taken place and title in the asset has passed to the entity, leaving the latter with an obligation to pay for it. In the case of a cash transaction, no liability would arise (par. 4.16).

There are a number of ways in which a liability may be settled or discharged, which include replacement by another obligation, conversion into equity, and the creditor waiving or forfeiting his rights. There are also various types of "past transactions or past events" from which liabilities may result (pars. 4.17–4.18). If a provision involves a present obligation and satisfies the rest of the definition of a liability given in the Framework, it is a liability even if the amount has to be estimated (par. 4.19).

OBSERVATION: Paragraph 4.19 does not emphasize the equally important point that a provision that fails to satisfy the criterion of being an *obligation* arising from a past transaction or past event is not a liability. This point, however, was crucial in arriving at the requirements for recognition of provisions in IAS 37, "Provisions, Contingent Liabilities, and Contingent Assets" (see Chapter 29).

Equity

Paragraphs 4.20–4.23 are concerned with equity. The fact that equity is defined as a residual interest (assets minus liabilities) does not mean that it cannot be meaningfully divided into subclassifications that are shown separately in the balance sheet. Examples are the differences among the following: (a) paid-in capital (capital stock and paid-in surplus); (b) retained earnings; (c) reserves representing appropriations of retained earnings; and (d) reserves representing the amounts required to be retained in order to maintain "real" capital, that is, either real financial capital or (real) physical capital.

There are various legal, tax, and valuation considerations that affect equity, such as requirements for legal reserves, and whether or not the enterprise is incorporated. It is emphasized that transfers to legal, statutory, and tax reserves are appropriations of retained earnings and not expenses. (Likewise, releases from such reserves are credits to retained earnings and not income, but this is not spelled out.) The rather obvious point is made that the amount at which equity is shown in the balance sheet is not intended to be a measure of the market value of the entity, either as a going concern or in a piecemeal disposal. It is stated that

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the definition and treatment of equity in the Framework are appropriate for unincorporated enterprises, even if the legal considerations are different.

Performance

Paragraphs 4.24–4.36 contain the section of the Framework in which definitions of the financial statement elements relating to performance are given. "Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment and earnings per share" (par. 4.24). However, this section of the Framework does not discuss the relationship between the elements of performance and the profit measure, except to say that "the recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the entity in preparing its financial statements." The determination of profit and related issues are discussed in a later section of the Framework (pars. 4.57–4.65).

The elements of income and expenses are defined as follows:

1. Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
2. Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants (par. 4.25).

These definitions identify the essential features of income and expenses but do not attempt to specify their recognition criteria (par. 4.26).

OBSERVATION: The definitions given above make it clear that the Framework's approach treats the definitions of assets and liabilities as *logically prior to* those of income and expenses. This is sometimes characterized as a "balance sheet approach" to the relationship between financial statements. This term is potentially misleading, however. The Framework's approach should certainly not be understood as implying the subordination of the income statement to the balance sheet from an *informational* perspective.

Income and expenses may be presented in different ways in the income statement in order to provide relevant information. An example given is the distinction between items of income or expense that arise in the course of the ordinary business activities of the particular entity and those that do not (a distinction required by IAS 1, "Presentation of Financial Statements"; see Chapter 4). Combining items of income and expense in different ways also permits different measures of entity performance to be provided. Examples are the alternative income statement formats with different analyses of expenses, by nature and by function (pars. 4.27–4.28). (These different formats are discussed in IAS 1, pars. 102–103; see Chapter 4).

Income

The Framework's definition of income encompasses both revenue and gains. Revenue is described as arising in the course of the ordinary activities of an entity and includes sales, fees, interest, royalties, and rent. Gains may or may not arise in the course of ordinary activities. Gains may arise on the disposal of non-current assets and also include unrealized gains such as those arising on the revaluation of marketable securities and from increases in the carrying amount of long-term assets. Gains, when recognized in the income statement, are usually displayed separately because their economic significance tends to differ from that of revenue, and they are often reported net of related expenses (pars. 4.29–4.32).

The counterpart entry corresponding to a credit for income may be to various asset accounts (not only cash or receivables), or to a liability account such as when a loan is discharged by the provision of goods or services.

Expenses

The Framework's definition of expenses encompasses losses as well as expenses that arise in the course of the ordinary activities of the enterprise. Examples given of expenses that arise in the course of ordinary activities are cost of sales, wages, and depreciation. They usually take the form (that is, are the accounting counterpart) of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, or plant and equipment (par. 4.33).

Losses represent items that may or may not arise in the course of ordinary activities. They include those that result from such disasters as fire or flood, as well as those arising on the disposal of non-current assets, and also encompass unrealized losses, such as those arising from the effects of adverse currency exchange rate movements on financial assets or liabilities. Losses, when recognized in the income statement, are usually displayed separately because their economic significance tends to differ from that of other expenses, and they are often reported net of related income (pars. 4.34–4.35).

OBSERVATION: Paragraphs 4.31 and 4.35 contain the phrases "when gains are recognized in the income statement" and "when losses are recognized in the income statement." IASs require or allow certain unrealized gains to be included directly in equity (e.g., certain revaluation surpluses on non-current assets and foreign exchange gains), or to have their recognition deferred until realization occurs. IASs also require or allow certain losses, such as revaluation losses and foreign exchange losses, to be included directly in equity. Thus, the issue of recognition in the income statement needs to be considered in the context of individual IASs.

It is stated in paragraph 4.32 that "various kinds of assets may be received or enhanced by income." Likewise, expenses are described in paragraph 4.33 as "usually tak[ing] the form of an outflow or depletion of assets . . . ." We believe that such points are made more clearly by using the accounting relationships, in virtue of which the income statement effect is the reflection or counterpart of (rather than merely consisting of) the related balance sheet movement. The importance of the accounting relationships in the context of recognition is mentioned in paragraph 4.39 (see below).

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Capital Maintenance Adjustments

The effects on equity of revaluations or restatements of assets and liabilities meet the Framework's definitions of income and expenses, but their inclusion in the income statement depends on which concept of capital maintenance is being applied (par. 4.36). This matter is discussed further below.

RECOGNITION OF THE ELEMENTS OF FINANCIAL STATEMENTS

Recognition issues are dealt with in paragraphs 4.37–4.53. Recognition is described as "the process of incorporating in the balance sheet or [the] income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 4.38." (The statement of changes in financial position is not mentioned because its elements consist of those that are also elements of financial position or performance.) Failure to recognize *in the main financial statements* items that satisfy the relevant definition and recognition criteria is not rectified by disclosure of the accounting policies used or by use of notes or other explanatory material.

The recognition criteria set out in paragraph 4.38 are that an item which meets the definition of an element should be recognized if:

1. It is probable that any future economic benefit associated with the item will flow to or from the entity; and
2. The item has a cost or value that can be measured with reliability.

Recognition is subject to materiality. Accounting interrelationships are also significant, since recognition in the financial statements of an item that meets the definition and recognition criteria for a particular element, for example an asset, entails the recognition of another (counterpart) element, such as income or a liability (par. 4.39). (This refers, strictly speaking, to the initial recognition of an item. However, a similar point could be made about the implications of remeasurement or valuation adjustments.)

The Probability of Future Economic Benefit

The concept of *probability* is used in the recognition criteria "to refer to the degree of uncertainty [as to whether] the future economic benefits associated with the item will flow to or from the enterprise . . . in keeping with the uncertainty that characterizes the environment in which an enterprise operates." Assessments of such uncertainty are made on the basis of the evidence available when the financial statements are prepared. In regard to receivables, for example, for a large population of accounts, some statistical evidence will usually be available regarding collectibility (par. 4.40).

OBSERVATION: The Framework does not offer any guidance, beyond that mentioned above, on the interpretation of "probable." IAS 37, "Provisions, Contingent Assets and Contingent Liabilities," contains an interpretation of "probable" as "more likely than not," that is, a probability in excess of 50%, but states that this interpretation is not intended to be applied in other contexts. Others have suggested an interpretation of "probable" in the present context as a probability of at least 75%. However, in the case of the receivables example mentioned above, the allowance to be made for probably uncollectible accounts would normally be based on past statistics, perhaps adjusted to take account of the current economic environment.

Reliability of Measurement

Reliability, the second recognition criterion, was discussed in the section "Qualitative Characteristics of Financial Statements" above. If an item does not possess a cost or value that can be measured with reliability (so that the information has that qualitative characteristic), then it is not appropriate to recognize it. However, in many cases, cost or (more particularly) value must be estimated; indeed, the use of reasonable estimates is an essential part of the financial reporting process and need not undermine reliability. In cases where an item satisfies the definition of an element but not the recognition criteria, it will not be recognized in the financial statements themselves, but its relevance is likely to require its disclosure in the notes to the financial statements or in other supplementary disclosures. This applies when the item meets the probability criterion of recognition but not the reliability criterion, but may also apply to an item that meets the definition of an element when neither recognition criterion is met. The key issue here is whether the item is considered to be relevant to the evaluation of financial position, performance, or changes in financial position. An item that does not satisfy the recognition criteria for an asset or a liability at one time may do so later, if more information relevant to estimating its probability, cost, or value becomes available (pars. 4.41–4.43).

OBSERVATION: The concept of a "reasonable estimate" is clearly crucial in the application of the reliability criterion, but the Framework gives no guidance on how it is to be interpreted. While this will not generally be a problematic issue in relation to the ascertainment of cost, estimating value can be problematic. This issue is dealt with in individual IASs, such as the requirement for an active market on which to base estimates in IAS 39, "Financial Instruments: Recognition and Measurement" (see Chapter 17).

On the issue of the retrospective recognition as an asset of an item of expenditure that has previously been recognized as an expense, IAS 38, "Intangible Assets" (see Chapter 22) does not permit the retrospective capitalization of development costs once they have been written off to expense.

Recognition of Assets

An asset is recognized in the balance sheet when it is probable that future economic benefits will flow to the entity (as a result of its control of the asset) and the asset's cost or value can be measured reliably. When expenditure has been incurred but it is not considered probable that economic benefits will flow to the entity beyond the current accounting period, this expenditure will be recognized as an expense, not as an asset. The intention of management in undertaking the expenditure is irrelevant (pars. 4.44–4.45).

Recognition of Liabilities

A liability is recognized in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount of that settlement can be measured reliably. Obligations under executory contracts, that is, non-cancelable contracts that are equally proportionately unperformed (such as the amount that will be a liability when inventory ordered and awaiting delivery is received), are not generally recognized as liabilities in the balance sheet, nor are the related assets recognized in the balance sheet. In some cases, however, recognition may be required (par. 4.46).

OBSERVATION: The treatment of executory contracts is to some extent an open issue in IASB GAAP. Inventory ordered under a non-cancelable contract is not "a resource controlled by" the entity that placed the order until title to the inventory has passed to it, and thus does not satisfy the Framework's definition of an asset of that entity. In such a case, it would be illogical to insist that the price to be paid for the inventory be recognized as a liability of that entity, since there would be no counterpart item to be recognized (recognition of an expense would make no sense).

There may, however, be other types of executory contracts (e.g., involving financial instruments) in respect of which recognition of an asset (or expense) and a related liability (or income) may be the most appropriate treatment.

Recognition of Income

Recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (or a combination of the two). The normal recognition procedures used in practice are applications of the Framework's recognition criteria. An example is the requirement that revenue should be earned (that is, it should be associated with a simultaneous increase in assets or decrease in liabilities). These procedures are concerned with restricting the recognition of income to items that, in effect, meet the Framework's recognition criteria of *probability* (a sufficient degree of certainty that an economic benefit has flowed or will flow to the entity) and *reliability* of measurement (pars. 4.47–4.48). (See Chapter 32, "Revenue.")

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An entity should disclose each of the following for contracts in progress at the balance sheet date:

1. The aggregate amount of costs incurred and recognized profits (less recognized losses) to date,
2. The amount of advances received, and
3. The amount of retentions.

An entity should present:

1. The gross amount due from customers for contract work as an asset, and
2. The gross amount due to customers for contract work as a liability.

IAS 37, "Provisions, Contingent Liabilities, and Contingent Assets" (see Chapter 29), should also be applied if appropriate.

IAS 11 gives, as an appendix, a long example and illustration that is worthy of study.

FUTURE DEVELOPMENTS

In June 2014, after a long and difficult gestation process, the IASB finally issued a new standard, IFRS 15, "Revenue from Contracts with Customers." The standard will replace both IAS 11, "Construction Contracts," and IAS 18, "Revenues." The general proposal is that no revenue should be recognized from a good or service until control of that good or service has passed to the buyer. In the context of construction contracts this could imply a delay in revenue recognition in some cases, as compared with IAS 11.

IFRS 15 was declared as mandatory for financial periods beginning on or after January 1, 2017, with earlier application permitted. Following considerable anxiety and pressure, this has now been formerly delayed until January 1, 2018. Between now and the final adoption, some entities will be using IAS 11 for construction activities, while others will not. As the differences in reported numbers could be significant, care will be needed. *Note* that a new standard very similar to IFRS 15 is being introduced into U.S. GAAP (Topic 606), originally compulsory with effect from December 16, 2016, with early application NOT permitted, but again now with a 12-month delay. International consistency over the next couple of years will not be achieved. (IFRS 15, "Revenue from Contracts with Customers," is discussed in detail in Chapter 32.)

CHAPTER 13
EARNINGS PER SHARE

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OVERVIEW

Earnings per share (EPS) is an important summary indicator of corporate performance for investors and other users of financial statements, relating the total earnings of the enterprise to the number of shares issued. It is an essential component in the Price/earnings (PE) ratio, which provides a basis of comparison between listed enterprises, and an indicator of market confidence, calculated as market price per share divided by EPS. High expectations of future performance lead to, and are indicated by, a higher share price and therefore a higher PE ratio.

Earnings per share figures are required by IASB GAAP to be presented in published financial statements in two forms. The basic EPS reports the EPS essentially as achieved in current circumstances. The diluted EPS calculates the EPS as if the dilutive effect of "potential" ordinary or common shares currently foreseeable had already taken place, that is, it assumes that a likely future increase in the number of shares has already happened. Intuitively, diluted EPS will be lower than basic EPS, but this need not be the case universally as the numerator may be increased as well as the denominator.

IAS 33, "Earnings per Share," became operative from January 1, 1998. There was considerable cooperation in this area between the IASC, the U.S. FASB, and the U.K. ASB. IAS 33, FAS-128 (i.e., ASC 260) in the United States, and FRS-14 in the United Kingdom were developed in cooperation and were consistent in all significant respects with each other.

A revised version of IAS 33 was issued in March 2004, applicable for annual periods beginning on or after January 1, 2005, with earlier application encouraged. The changes in this revision were of some importance but are of a technical rather than fundamental nature.

BACKGROUND

EPS is widely regarded as an important and convenient indicator of enterprise performance. In many ways, this is an unsatisfactory state of affairs. Accountants and regulators nationally and internationally have made enormous efforts to prescribe and increase transparency and clarity of reporting, but EPS goes out of its way to seek to reduce a voluminous and complex set of information to a single statistic. While in one sense wishing to downgrade the importance attached to EPS, regulators have inevitably found it necessary to make the EPS figure as reliable and consistent as possible. The earnings figure is relatively easy to regulate in terms of "which figure off the income statement to use," and impossible to regulate in terms of the inherent subjectivity involved in some aspects of revenue and expense calculation. Most of the detail of IAS 33, "Earnings per Share," is concerned with the calculation of the denominator in the EPS ratio, that is, with the actual or imputed number of shares.

SCOPE AND DEFINITIONS

IAS 33 must be applied by entities whose ordinary shares or potential ordinary shares are publicly traded and by entities that are in the process of issuing ordinary shares or potential ordinary shares in public markets. Any other entity that discloses earnings per share should calculate and disclose earnings per share in accordance with the standard.

When an entity presents both consolidated financial statements and separate financial statements prepared in accordance with IFRS 10, "Consolidated Financial Statements," and IAS 27, "Separate Financial Statements," the disclosures required by IAS 33 need be presented only on the basis of the consolidated information. An entity that chooses to disclose earnings per share based on its separate financial statements must present such EPS information only on the face of its separate statement of comprehensive income. An entity shall not present such EPS information in the consolidated financial statements. This last prohibition, a new introduction compared with the previous version, is to avoid confusion for the readers of the consolidated financial statements. In a similar vein, if an entity presents the components of profit or loss in a separate income statement, following paragraph 10A of IAS 1, "Presentation of Financial Statements," as revised in 2011 (see Chapter 4), it presents its EPS information only in that separate statement. The standard notes that the IAS 32 definitions of financial instrument, financial asset, financial liability and equity instrument should be assumed to apply (see Chapter 17), as should the IFRS 13 definition of fair value (see Chapter 3). Other definitions are given in IAS 33 as follows (par. 5):

- *Dilution* is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.
- *Options, warrants, and their equivalents* are financial instruments that give the holder the right to purchase ordinary shares.

- An *ordinary share* is an equity instrument that is subordinate to all other classes of equity instruments.
- A *potential ordinary share* is a financial instrument or other contract that may entitle its holder to ordinary shares.
- *Put options* on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.
- *Antidilution* is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.
- A *contingent share agreement* is an agreement to issue shares that is dependent on the satisfaction of specified conditions.
- *Contingently issuable ordinary shares* are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.

The definition of an ordinary share as "subordinate to all other classes" implies that there is only one class of ordinary shares and, conversely, that all ordinary shares are of the same class. However, this is not in general the case. The standard states explicitly (par. 6) as follows.

> Ordinary shares participate in profit for the period only after other types of shares, such as preference shares, have participated. An entity may have more than one class of ordinary shares. Ordinary shares of the same class have the same rights to receive dividends.

Further ambiguity arises from a comparison of the above statement, which distinguishes ordinary shares in terms of their rights to participate in net profit, with the definition of an equity instrument in IAS 32, which is couched purely in terms of rights to participate in a residual interest in net assets. The one need not automatically embrace the other.

It is possible to envisage complex equity structures creating apparently anomalous situations. For example, two types of shares could exist, A and B, both participating in residual net profits and having an interest in residual net assets, but with A also having an additional fixed preferential dividend entitlement. Clearly A, as a participating preference share, has some preference over B, so therefore B is subordinate to A. The definition of an ordinary share in IAS 33 would then clearly indicate that only B is an ordinary share, despite the fact that A also participates in residual net profit. On the other hand, two types of share could exist where the dividend entitlement of one, while neither fixed nor preferential, is stated as having a fixed proportional relationship to that of the other. Both types meet the definition (provided they also participate, whether equally or otherwise, in the residual net assets on dissolution also), so both are ordinary shares, but they are clearly distinguishable and would be expected to have different market values.

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BASIC EARNINGS PER SHARE

Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to ordinary shareholders, the numerator, by the weighted average number of ordinary shares outstanding during the period, the denominator. Note that the numerator is the net result after deducting preference dividends (and in principle after deducting the returns to any other share class other than the ordinary shares). An entity should calculate basic EPS amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

The amount of preference dividends that is deducted from the net profit for the period is the amount of any preference dividends on noncumulative preference shares declared in respect of the period, and the full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been declared. It follows that any dividends paid or declared during the current year in relation to cumulative preference shares in respect of previous period have been dealt with in earlier years, and should not be deducted in the current period EPS calculation.

OBSERVATION: This simple definition of earnings for EPS purposes masks two issues that had caused some controversy in earlier years: tax considerations and unusual items. Under a number of jurisdictions the distribution policy affects the total taxation payable by a company on its income. Because "earnings" are supposed to be gross of dividends to ordinary shareholders and any effects thereof, it has been suggested that in such circumstances tax effects should be adjusted to give theoretical comparability between enterprises with different dividend policies. IAS 33 ignores this issue, simply requiring earnings to be calculated after all tax effects of the actual activities have been taken into account.

Unusual items are likewise not discussed in IAS 33. There had been much discussion in earlier years to the effect that EPS, as an indicator of likely repeatable performance, should exclude the effects of extraordinary items. However, the subjectivity of definition caused considerable difficulty and distortion (if not creativity) where this was tried. IAS 33 sweeps this issue, too, into oblivion by automatically requiring earnings to be calculated after the effects of all such items.

The denominator in the basic EPS calculation is potentially more difficult to calculate. It should be the weighted average number of ordinary shares outstanding during the period. This is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor. The time-weighting factor is the number of days that the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances. In most cases, shares are included in the weighted average number of shares from the date consideration is receivable (which is generally the date of their issue).

Some simple illustrations may be useful. Consider first the situation where an enterprise issues shares partway through the year at full market price.

I. Fullmar had total issued share capital on December 31, 20X1, as follows:

500,000 7% $1 preference shares

4,000,000 25¢ ordinary shares

Profit after tax for the year ended December 31, 20X1, was $435,000. On October 1, 20X1, Fullmar had issued 1 million 25¢ ordinary shares at full market price

The EPS for the year ended December 31, 20X1, would be calculated as follows.

The number of ordinary shares in issue on January 1, 20X1, was 3 million, and 1 million were issued on October 1, 20X1. Thus, the time weighted average number of ordinary shares in issue for the year was

3,000,000 × (9/12) + 4,000,000 × (3/12) = 3,250,000

The earnings for the year attributable to the ordinary shareholders is $435,000 – 35,000 preference dividend = $400,000. Therefore,

EPS = (40,000,000/3,250,000)¢ per share = 12.3¢ per share.

A second situation is when the number of shares is increased by a capitalization or bonus issue, that is, the shares are issued for zero consideration, leading of course to no change in the resources available to the enterprise.

The standard (par. 26) logically requires that the weighted average number of ordinary shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential ordinary shares, that have changed the number of ordinary shares outstanding without a corresponding change in resources.

II. Using the same data as above, except that Fullmar issued the shares on October 1, 20X1, as bonus shares, EPS for 20X1 would be as follows.

We now have a capitalization issue, not a full market price issue, of shares and therefore we assume 4 million shares in issue for the whole of the year. (Note: This assumption would be the same no matter at what point during the year the capitalization was made.)

The number of shares in issue can also be calculated using the following:

3,000,000 × (9/12) (4/3) + 4,000,000 × (3/12)

(bonus factor)

= 3,000,000 + 1,000,000 = 4,000,000

EPS = (40,000,000/4,000,000) = 10¢ per share

The above calculation gives the EPS figure for the year 20X1. However, comparability (and paragraph 26 as quoted) requires the adjustment of all prior period EPS figures presented in the 20X1 financial statements.

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If the EPS for the year ended December 31, 20X0, for Fullmar was 8¢, how would this figure have to be adjusted for the bonus issue for the 20X1 financial statements?

The bonus issue represents a 1 for 3 share issue, that is, the number of shares has increased by one-third; therefore, we must have four-thirds times the original number of shares and the EPS will be multiplied by three-quarters, that is:

8¢ × (3/4) = 6¢

The third situation is where shares are issued partway through the year for consideration but at less than the full market price, as is likely to be the case with a "rights issue." In a rights issue, the exercise price is often less than the fair value of the shares. Therefore, such a rights issue includes a bonus element. The number of ordinary shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of ordinary shares outstanding prior to the issue, multiplied by the following factor:

Theoretical ex-rights fair value per share/Fair value per share immediately prior to the exercise of rights

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights and dividing by the number of shares outstanding after the exercise of the rights. Where the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Thus, a rights issue combines the characteristics of a capitalization issue and a full market price issue. New resources are passing into the business, so a higher earnings figure, related to these new resources, should be expected. At the same time, however, there is a bonus element in the new shares, which should be treated like a capitalization issue. To the extent that the rights issue provides new resources, that is, equates to an issue at full market price, we need to calculate the average number of shares weighted on a time basis. To the extent that the rights issue includes a discount or bonus element, we need to increase the number of shares deemed to have been in issue for the whole period.

III. Illustration of effect of a rights issue:

On June 30, 20X1, Trig has 6,000,000 $1 ordinary shares in issue with a current market value of $2 per share. On July 1, 20X1, Trig makes a four for six rights issue at $1.75, and all rights are taken up. Earnings for the year after tax and preference dividends are $81,579 and the previous year's EPS was declared as 9¢. Calculate the EPS figure that should be shown in the financial statements for the year ended December 31, 20X1.

We first need to calculate the theoretical ex-rights price of the shares:

Market value of equity before rights	=	600,000 × $2	=	$1,200,000
Proceeds from rights issue	=	400,000 × $1.75	=	700,000
		1,000,000		$1,900,000

Theoretical ex-rights price = (1,900,000/1,000,000) = $1.90

Secondly, we calculate the weighted average number of shares:

600,000 × (1/2) × (2/1.9) + 1,000,000 × (1/2) = 815,789
(time weighting) (time weighting)

Therefore, EPS for year ending December 31, 20X1 = (8,157,900/815,789) = 10¢ per share

Third, we need to recalculate the previous year's EPS in order to make the comparative figure comparable with the current figure as reported.

9 × (1.9/2) = 8.55¢ per share

A reduction has occurred in the previous year's EPS as we have retrospectively inserted the bonus element of the rights issue.

There are some exceptions to the general rule that shares are to be included in the weighted average number from the date consideration is receivable.

Ordinary shares issued as part of the purchase consideration of a business combination that is treated as an acquisition are included in the weighted average number of shares as of the date of the acquisition, because the acquirer incorporates the results of the operations of the acquiree into its income statement from the date of acquisition.

Where ordinary shares are issued in partly paid form, these partly paid shares are treated as a fraction of an ordinary share (i.e., the proportion of payments received to date over the full subscription price) to the extent that they were entitled to participate in dividends relative to a fully paid ordinary share during the financial period.

Ordinary shares that are issuable upon the satisfaction of certain conditions (contingently issuable shares) are considered outstanding and included in the computation of basic earnings per share from the date when all necessary conditions have been satisfied. Outstanding ordinary shares that are contingently returnable (that is, subject to recall) are excluded from the calculation of basic EPS until the date the shares are no longer subject to recall.

Any different types of unusual share transaction should be treated in accordance with the substance of the situation and consistently with the principles outlined in the above text and illustrations. Further illustrations are given in IAS 33, Appendix A.

DILUTED EARNINGS PER SHARE

Where there are securities existing at the year-end that will have a claim on equity earnings from some time in the future, then it is clear that at this future time the claim of each currently existing share will, other things equal, be reduced (or diluted). It is likely to be useful information to current shareholders and others to give them a picture of what the EPS would be if this dilution takes place. This is done by recalculating the current year's EPS as if the dilution had already occurred.

For the purpose of calculating diluted earnings per share, the net profit attributable to ordinary shareholders and the weighted average number of shares

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outstanding both should be adjusted for the effects of all dilutive potential ordinary shares. This means that:

1. The net profit for the period attributable to ordinary shares is increased by the after-tax amount of dividends and interest recognized in the period in respect of the dilutive potential ordinary shares and adjusted for any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares, and
2. The weighted average number of ordinary shares outstanding is increased by the weighted average number of additional ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares.

Although this situation is by its nature more complicated than the calculation of basic earnings per share, the adjustments for the numerator, the earnings figure, are relatively straightforward, provided all aspects of the changes are considered. For example, if a convertible debenture exists, then the diluted EPS calculation requires the assumption that the conversion has already taken place. This assumption leads not only to an increase in the number of (assumed) shares, it also leads to the necessity to remove the interest charge on the debentures from the net profit calculation (after tax).

Formally, the net profit or loss attributable to ordinary shareholders is adjusted for the after-tax effect of the following (par. 33):

1. Any dividends on dilutive potential ordinary shares that have been deducted in arriving at the net profit attributable to ordinary shareholders as calculated for the basic EPS,
2. Interest recognized in the period for the dilutive potential ordinary shares, and
3. Any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares, such as bonus or profit-sharing schemes based on reported earnings.

Regarding the denominator in the diluted EPS calculation, that is, the number of shares, the number of ordinary shares should be the weighted average number of ordinary shares calculated as for the basic EPS, plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Dilutive potential ordinary shares should be deemed to have been converted into ordinary shares at the beginning of the period or, if later, the date of the issue of the potential ordinary shares. The calculation should be based on the terms of issue of the potential ordinary shares and should assume the most advantageous conversion rate or exercise price from the viewpoint of the holder.

Illustration of Calculation of Basic and Diluted EPS

The summarized income statement for the year ended 20X1 is as follows:

	$000	$000
Profit before taxation		1,000
Taxation		400
		600
Preference dividend	50	
Ordinary dividend	100	
		150
		450

The number of ordinary shares in issue is 2 million.

Calculate the basic EPS.

Basic EPS = (Profit after tax less preference dividend/Number of ordinary shares)
= (60,000,000 – 5,000,000)/2,000,000
= 27.5¢ per share

Assume now that, in addition to the 2 million ordinary shares already in issue, however, there exists convertible loan stock of $500,000 bearing interest at 10%. This may be converted into ordinary shares between 20X3 and 20X6 at a rate of one ordinary share for every $2 of loan stock. Taxation is taken for convenience as 50%.

The fully diluted EPS is found as follows. If the conversion is fully completed, then there will be two effects:

1. The share capital will increase by 250,000 shares (1 share for every $2 of the $500,000 loans).
2. The profit after tax will increase by the interest on the loan no longer payable less the extra tax on this increase. The interest at 10% on $500,000 is $50,000, but the extra tax on this profit increase would be 50% of $50,000, that is, $25,000.

So profit after tax, and therefore "earnings," will increase by 50,000 – 25,000 = $25,000. Fully diluted EPS will therefore be:

$(600{,}000 + 25{,}000 - 50{,}000)/(2{,}000{,}000 + 250{,}000)$

$= (57{,}500{,}000/2{,}250{,}000)¢$

$= 25.6¢$ per share

IAS 33 discusses a number of possible complications in some detail, in paragraphs 41–63.

As in the computation of basic earnings per share, ordinary shares whose issue is contingent upon the occurrence of certain events are considered outstanding and included in the computation of diluted earnings per share if the

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conditions have been met. Contingently issuable shares should be included as of the beginning of the period (or as of the date of the contingent share agreement, if later). If the conditions have not been met, the number of contingently issuable shares included in the diluted earnings per share computation is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period (which, of course, could be zero).

If a group company other than the parent issues instruments that are potentially convertible into ordinary shares of the parent, then they should be included in the calculation of consolidated diluted EPS.

Options and other share purchase arrangements are dilutive when they would result in the issue of ordinary shares for less than fair value. The amount of the dilution is fair value less the issue price. Fair value for this purpose is calculated on the basis of the average price of the ordinary shares during the period. For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential ordinary shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issued and the number of shares that would have been issued at fair value should be treated as an issue of ordinary shares for no consideration. Such ordinary shares generate no proceeds and have no effect on the net profit attributable to ordinary shares outstanding. Therefore, such shares are dilutive, and they are added to the number of ordinary shares outstanding in the computation of diluted earnings per share.

The illustration of the calculation of diluted EPS given above showed the common situation where, compared with the calculation of basic EPS, both the numerator and the denominator are increased. The effect in that case was a lower EPS figure, and indeed that is what the word *diluted* indicates. It is clearly possible, however, depending on the relative effect of the adjustments to numerator and denominator, for the effects to be antidilutive. Potential ordinary shares are antidilutive when their conversion to ordinary shares would increase earnings per share from continuing ordinary operations or decrease loss per share from continuing ordinary operations. The effects of antidilutive potential ordinary shares are ignored in calculating diluted earnings per share.

In considering whether potential ordinary shares are dilutive or antidilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate. The sequence in which potential ordinary shares are considered may affect whether or not they are dilutive. Therefore, in order to maximize the dilution of basic earnings per share, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive.

It is important to note that, while EPS is based on net profit or loss, the determination of whether potential ordinary shares are dilutive or antidilutive is based on net profit from continuing operations.

The inclusion of potential ordinary shares in the denominator of a diluted EPS calculation when the enterprise has a loss from continuing ordinary activities as defined above would automatically have an antidilutive effect (as it would

decrease loss per share). Such shares would therefore be ignored for calculating diluted EPS, even if the net profit (as opposed to net profit from continuing ordinary activities) is positive.

Potential ordinary shares are weighted for the period they were outstanding. Potential ordinary shares that were canceled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential ordinary shares that have been converted into ordinary shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting ordinary shares are included in both basic and diluted earnings per share.

When an entity has issued a contract that may be settled in ordinary shares or cash at the entity's option, the entity must presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares are included in diluted EPS if the effect is dilutive. For contracts that may be settled in ordinary shares or cash at the holder's option, the more dilutive of cash settlement and share settlement should be used in calculating diluted EPS.

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Contracts such as purchased put options and purchased call options (i.e., options held by the entity on its own ordinary shares) are not included in the calculation of diluted EPS, because including them would be antidilutive. This is because a put option would be exercised only if the exercise price were higher than the market price and the call option would be exercised only if the exercise price were lower than the market price.

Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are reflected in the calculation of diluted EPS if the effect is dilutive. If these contracts are "in the money" during the period (i.e., the exercise or settlement price is above the average market price for that period), the potential dilutive effect on EPS should be calculated as follows:

1. It should be assumed that at the beginning of the period sufficient ordinary shares will be issued (at the average market price during the period) to raise proceeds to satisfy the contract.
2. It should be assumed that the proceeds from the issue are used to satisfy the contract (i.e., to buy back ordinary shares).
3. The incremental ordinary shares (the difference between the number of ordinary shares assumed issued and the number of ordinary shares received from satisfying the contract) should be included in the calculation of diluted EPS.

RETROSPECTIVE ADJUSTMENTS

As discussed above in relation to IAS 33, paragraph 26, and as shown in Illustration II above, if the number of ordinary or potential ordinary shares outstanding increases as a result of a capitalization or bonus issue or share split or decreases as a result of a reverse share split, the calculation of basic and

diluted earnings per share for all periods presented should be adjusted retrospectively (par. 64). If these changes occur after the balance sheet date but before issue of the financial statements, the per share calculations for those and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed. In addition, basic and diluted earnings per share of all periods presented should be adjusted for the effects of errors and adjustments resulting from changes in accounting policies accounted for retrospectively.

Restatement of prior period diluted EPS to reflect a change in assumptions used is not allowed.

PRESENTATION AND DISCLOSURE

An entity must present in the statement of comprehensive income basic and diluted EPS for profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity and for profit or loss attributable to the ordinary equity holders of the parent entity, for the period, for each class of ordinary shares that has a different right to share in profit for the period. Basic and diluted EPS must be given equal prominence for all periods presented. These requirements apply even if basic and diluted EPS are identical (in which case a one-line presentation is acceptable), and even if the amounts are negative. An entity that reports a discontinued operation must disclose the basic and diluted amounts per share for the discontinued operation either in the statement of comprehensive income or in the notes to the financial statements. If an entity presents the components of profit or loss in a separate income statement, as described in paragraph 10A of IAS 1, "Presentation of Financial Statements," as revised in 2011 (see Chapter 4), it presents the basic and diluted EPS figures in that separate statement or the notes.

An entity shall disclose the following:

1. The amounts used as the numerators in calculating basic and diluted EPS, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period. The reconciliation must include the individual effect of each class of instruments that affects earnings per share.
2. The weighted average number of ordinary shares used as the denominator in calculating basic and diluted EPS and a reconciliation of these denominators to each other. The reconciliation should include the individual effect of each class of instruments that affects earnings per share.
3. Instruments (including contingently issuable shares) that could potentially dilute basic EPS in the future but were not included in the calculation of diluted EPS because they are antidilutive for the periods presented.
4. A description of ordinary share transactions or potential ordinary share transactions, other than those accounted for in accordance with paragraph 64, that occur after the balance sheet date and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.

Examples of transactions in item 4 include:

- An issue of shares for cash;
- An issue of shares when the proceeds are used to repay debt or preference shares outstanding at the balance sheet date;
- The redemption of ordinary shares outstanding;
- The conversion or exercise of potential ordinary shares outstanding at the balance sheet date into ordinary shares;
- An issue of options, warrants, or convertible instruments; and
- The achievement of conditions that would result in the issue of contingently issuable shares.

IAS 33 does not prevent the disclosure of *additional* calculations of performance-per-share ratios beyond those specified in the standard, but it is concerned with preventing either obfuscation of the "official" ratios or confusion by the reader of the financial statements. Accordingly, if an entity discloses, in addition to basic and diluted EPS, amounts per share using a reported component of the income statement other than one required by the standard, such amounts shall be calculated using the weighted-average number of ordinary shares determined in accordance with the standard. Basic and diluted amounts per share relating to such a component are to be disclosed with equal prominence and presented in the notes to the financial statements. An entity should indicate the basis on which the numerators are determined, including whether amounts per share are before tax or after tax. If a component of the income statement is used that is not reported as a line item in the income statement, a reconciliation must be provided between the component used and a line item that is reported in the income statement.

OBSERVATION: There has been much debate in recent years (and little agreement!) about the implications of 'comprehensive income' as compared with the 'earnings' figure as discussed in this chapter, and which appears as the net result at the end of the 'profit or loss' account. Both are in different ways implications of the performance of the entity through the year. We make no judgement and no comment on whether or not the 'total comprehensive income' figure is a 'good' indication of performance. We merely make the point that to the extent that it is indeed regarded as useful, at least for some purposes, then it logically follows that 'total comprehensive income per share' would also be a useful comparative statistic. Conversely, reporting of both this and earnings per share might be regarded as causing confusion to the unsophisticated reader.

We are not aware of any movements towards, or serious discussion about, reporting information in this direction.

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recognized at that date but applies IAS 38 to reassess their useful lives and any resultant changes in the useful lives are accounted for as a change in an accounting estimate in accordance with IAS 8 (IAS 38, par. 130).

A number of amendments were made to IAS 38 in 2008 in conjunction with the revisions of IAS 1 and IFRS 3, applicable for annual periods beginning on or after January 1, 2009, for those made in conjunction with IAS 38 and July 1, 2009, for those made in conjunction with IFRS 3. A minor amendment was made to IAS 38 in April 2009 clarifying the requirements regarding the acquisition of intangibles as part of a business combination and the description of valuation techniques commonly used to measure intangible assets at fair value when such assets are not traded in an active market. These amendments should be applied prospectively for annual periods beginning on or after July 1, 2009. Earlier application was permitted but should be disclosed.

CHAPTER 23 INTERIM FINANCIAL REPORTING

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OVERVIEW

Annual financial statements are something of a blunt instrument. They cover a long period and do not appear until a considerable time after the end of that period. It is helpful to many users of financial statements to receive one or more progress reports at interim times and/or at shorter intervals. This is a requirement of most stock exchanges, which are likely to issue their own regulations on such statements for their own listed companies. It is also good public relations to appear to wish to keep an image of openness and transparency with one's investors, lenders, and customers.

The practice of issuing interim financial information has become more prevalent generally among listed entities in recent years. Clearly, as with the annual financial statements themselves, consistency, clarity of policy, and adherence to fair presentation are essential. IASB GAAP do not *require* the publication of interim financial reports. However, if an entity reporting under IASB GAAP does choose (or is required by other authorities) to issue such reports, then IASB GAAP prescribes the minimum content of an interim financial report, and the principles for recognition and measurement in complete or condensed financial statements for an interim period.

IASB GAAP is contained in IAS 34, "Interim Financial Reporting," IFRIC 10, "Interim Financial Reporting and Impairment," is also relevant. Further, minor amendments have been made.

BACKGROUND

There are two possible ways of viewing the preparation of interim financial statements. The first, known as the *discrete approach*, views interim periods like any other accounting period, only shorter. The second, known as the *integral approach*, views an interim period as a component, or integral, part of the annual reporting period. Within this second approach, the purpose of interim financial

reporting is to provide information over the course of the annual period that helps to anticipate annual results.

To some extent, IASB GAAP follow the second integral philosophy. They do not require that seasonal or cyclical revenues or expenses are smoothed out, as they can be properly interpreted as indicators of annual performance, given proper comparison figures plus further explanation if necessary. IAS 34 seeks to ensure that such meaningful comparison and necessary explanation are provided. There are no major differences between IASB and U.S. GAAP as promulgated in ASC 270. It should be remembered as a general point, however, that many stock exchanges have their own rules in relation to enterprises quoted thereon.

SCOPE AND DEFINITIONS

As already indicated, IASB GAAP do not of themselves require the preparation and publication of interim financial reports by any entity, listed or otherwise. The fact that an entity may not have provided interim financial reports during a particular financial year or may have provided interim financial reports that do not comply with IAS 34 does not prevent the entity's annual financial statements from conforming to international standards if they otherwise do so. However, if an entity's interim financial report is described as complying with international standards, it must comply with all of the requirements of IAS 34. Thus, IAS 34 applies to all entities that are required, or elect, to publish an interim financial report in accordance with international standards. The IASB "encourages" publicly traded (listed) entities (par. 1) to provide interim financial reports at least as of the end of the first half of their financial year and to make their interim financial reports available not later than 60 days after the end of the interim period.

The standard gives two formal definitions, as follows (par. 4):

1. *Interim period* is a financial reporting period shorter than a full financial year.
2. *Interim financial report* means a financial report containing either a complete set of financial statements (as described in IAS 1, "Presentation of Financial Statements" (see Chapter 4)) or a set of condensed financial statements (as described in this standard) for an interim period.

IAS 34 makes it clear that it does not intend in any way to "discourage" the issue of an interim complete set of financial statements, that is, in full accord with IAS 1 (which requirement automatically embraces all other applicable IASs). The IAS itself, however, specifies the minimum components of an interim financial report as follows (par. 8):

1. A condensed statement of financial position.
2. A condensed statement or condensed statements of profit or loss and other comprehensive income.
3. A condensed statement of changes in equity.
4. A condensed statement of cash flows.
5. Selected explanatory notes.

It is to be assumed that a reader of an interim financial report also has access to the previous full annual financial statements. The interim report, therefore, focuses on new circumstances and need not duplicate information previously reported.

FORM AND CONTENT OF INTERIM FINANCIAL STATEMENTS

As already discussed, an entity may, if it chooses, issue its interim financial statements in full accord with IAS 1. Otherwise, if an entity publishes a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements and the selected explanatory notes as required by IAS 34. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading. Basic and diluted earnings per share should be presented on the face of each income statement, complete or condensed, for each interim period.

The interim report should be as consistent as possible, for example, regarding consolidation, with the most recent annual financial statements. The condensed changes in equity statement (see component 3, above) should also be consistent with that of the annual statements.

This relatively brief comment deals with components 1–4 of the condensed interim report. The element of subjectivity involved in the question of "additional line items or notes" should be observed. However, IAS 34 deals with the content of required explanatory notes (note that component 5 does not include the word "condensed") in detail. Again, it is assumed that the previous full financial statements are available to the reader, so the notes in the interim reports should focus on an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the enterprise since the last annual reporting date (pars. 15–15C).

In addition to disclosing significant events and transactions in accordance with paragraphs 15–15C, an entity shall include the following information in the notes to its interim financial statements if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis as follows:

1. A statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change.
2. Explanatory comments about the seasonality or cyclicality of interim operations.
3. The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence.

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4. The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior years.
5. Issues, repurchases, and repayments of debt and equity securities.
6. Dividends paid (aggregate or per share) separately for ordinary shares and other shares.
7. The following segment information (disclosure of segment information is required in an entity's interim financial report only if IFRS 8, "Operating Segments," requires that entity to disclose segment information in its annual financial statements):
   a. Revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker.
   b. Intersegment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker.
   c. A measure of segment profit or loss.
   d. A measure of total assets and liabilities for a particular reportable segment if such amounts are regularly provided to the chief operating decision maker and if there has been a material change from the amount disclosed in the last financial statements for that reportable segment.
   e. A description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss.
   f. A reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to profit or loss after those items. Material reconciling items shall be separately identified and described in that reconciliation.
8. Events after the interim period that have not been reflected in the financial statements for the interim period.
9. The effect of changes in the composition of the entity during the interim period, including business combinations; obtaining or losing control of subsidiaries; and long-term investments, restructurings, and discontinued operations. In the case of business combinations, the entity shall disclose the information required by IFRS 3, "Business Combinations."
10. For financial instruments, the disclosures about fair value required by paragraphs 91-96, 98 and 99 of IFRS 13, "Fair Value Measurement," and paragraphs 25, 26, and 28–30 of IFRS 7, "Financial Instruments: Disclosures."

11. For entities becoming, or ceasing to be, investment entities, as defined in IFRS 10, "Consolidated Financial Statements," the disclosures in IFRS 12, "Disclosure of Interests in Other Entities," paragraph 9B.
12. The disaggregation of revenue from contracts with customers required by paragraphs 114-115 of IFRS 15, "Revenue from Contracts with Customers" (once IFRS 15 is adopted).

→ **PRACTICE POINTER:** The requirement to present information on a financial year-to-date basis *and* to ensure an understanding of the current interim period should be noted carefully. It logically has no effect in the context of half-yearly interim statements, but if interim statements are issued quarterly, then its implications could be significant. The notes included must satisfy the requirements of providing an understanding of the latest quarter (and its comparatives) and also an understanding of the year-to-date (and its comparatives).

A clear statement of disclosure of IAS compliance is required. This should specify either that the interim financial statements achieve *full* compliance with IAS 1, with all its implications, or specify that the interim financial statements achieve *full* compliance with IAS 34. No partial or "in all material respects" claims for compliance are permitted.

Interim reports are required to include interim financial statements as follows (par. 20):

1. Statement of financial position as of the end of the current interim period and a comparative statement of financial position as of the end of the immediately preceding financial year.
2. Statements of profit or loss and other comprehensive income for the current interim period and cumulatively for the current financial year to date, with comparative statements of profit or loss and other comprehensive income for the comparable interim periods (current and year-to-date) of the immediately preceding financial year. As permitted by IAS 1, an interim report may present for each period a single statement or statements of profit or loss and other comprehensive income.
3. Statement of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.
4. Statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

Illustration

To illustrate, suppose an entity's financial year ends December 31 (calendar year). The entity will present the following Statement or Statements of Profit or Loss and Other Comprehensive Income in its quarterly interim financial report as of June 30, 2007:

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Statement of Financial Position		
At	June 30, 2007	December 31, 2006
Statement of Comprehensive Income		
6 months ending	June 30, 2007	June 30, 2006
3 months ending	June 30, 2007	June 30, 2006
Statement of Cash Flows		
6 months ending	June 30, 2007	June 30, 2006
Statement of Changes in Equity:		
6 months ending	June 30, 2007	June 30, 2006

EPS figures would be required for each one of the four income statements presented. Entities whose business is highly seasonal are "encouraged to consider reporting," in addition to the above, financial information for the 12 months ending on the interim reporting date and comparative information for the prior 12-month period. Presumably, full compliance with IAS 34 does not strictly require this.

The question of materiality needs to be considered carefully. In deciding how to recognize, measure, classify, or disclose an item for interim financial reporting purposes, materiality should be assessed in relation to the interim period financial data. An event affecting an interim period may be material regarding that interim period but not material, or not expected to be material, in the context of a full financial year. Note that information is material if omitting it or misstating it could influence the economic decisions of users of the financial statements. If it is material in the context of the interim period, then IAS 34 requires its disclosure.

→ **PRACTICE POINTER:** Logically, if it is material for the interim period but possibly or probably not in the context of the whole year, the disclosure must be sufficiently detailed to make all the implications clear. Disclosure for the interim period, with no further comment, could be taken to imply a continuation of the situation over the remainder of the year, and thus its continuing materiality, which would be misleading. As IAS 34 puts it (par. 25), judgment must be exercised, remembering that the overriding goal is to ensure that an interim financial report includes all information that is relevant to understanding an enterprise's financial position and performance during the interim period.

Paragraph 16 A(d) (given as item 4 in the "Form and Content of Interim Financial Statements" section above) requires, where material, disclosure of changes in estimates used in previous interim periods within the year, in the current interim period. However, IAS 34 does not require the preparation of separate interim reports for the last interim period in the year (i.e., an entity reporting quarterly is required to present three quarterly reports and one annual report, not four quarterly reports and one annual report). This creates a lacuna dealt with by paragraph 26, which requires that if an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not published for that final interim period, the nature and amount of that change in estimate should be disclosed in a note to the annual financial statements for that financial year.

RECOGNITION AND MEASUREMENT

The key principle is that consistency of accounting policies is required between the annual statements and the interim statements. However, change in accounting policy is allowed under IAS 8 (see Chapter 6) and may be required by the issue of a new international standard or statement by the International Financial Reporting Interpretations Committee (IFRIC). The implications (par. 28) are that an entity should apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, the frequency of an entity's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.

The standard makes rather heavy weather of the implications of this, but the principle is quite simple. This is that the definitions of the elements, in particular, assets, liabilities, revenues, and expenses given in the IASB Framework (see Chapter 2), must be applied absolutely consistently between annual and interim statements. If an expenditure does not create an asset capable of recognition under the Framework as of the end of an interim period, then it must be treated as an expense in those interim results. Similarly, a liability can be recorded as such only if it represents an existing obligation as of the date of the interim period-end.

IAS 34 recognizes, as it must, that estimates and expectations, for example, concerning future benefits, will change as the full reporting year progresses, that is, they will change between interim reporting periods. An entity that reports more frequently than semiannually, measures income and expenses on a year-to-date basis for each interim period, using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Paragraphs 16 A(d) and 26 require, however, that the nature and amount of any significant changes in estimates be disclosed. These paragraphs also require, in the case of an entity that reports only semiannually, similar disclosure in the annual financial statements of significant changes in estimates used in the interim statements.

OBSERVATION: Some uncertainties of detail arise. For example, suppose an entity has a policy of remeasuring certain assets to fair value on a frequent and regular basis. Such remeasurements will be reflected in interim reports. Is the base carrying amount, for the calculation of gain or loss on disposal, that of the latest interim report, or that of the last annual report? Logic would suggest

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the latter, at least as it will be shown in the next full annual report, as an optional interim report should not logically affect the position in and between compulsory annual reports. But the formal position is unclear. Additionally in this situation, and also with provisions, for example, for inventory write-down or doubtful debts, estimates may reverse between interim periods. Disclosure, if material, is of course required under paragraph 16 A(d)—presumably in the later interim period, but not, if the *net* movement is immaterial, in the eventual annual report. When these mobile interim figures become comparatives in the following year, the spirit of the standard will need to be followed, rather than the (absent) letter, in order to give adequate and non-misleading disclosure.

IAS 34 explicitly confirms that revenues that are seasonal, cyclical, or occasional and costs that are incurred unevenly are (pars. 37 and 39) anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of item at the end of the financial year. In general, such items are recognized when they occur (with additional explanation under paragraph 16 A(b) as stated above as item 2 in the "Form and Content of Interim Financial Statements" section), if appropriate.

IAS 34 notes and effectively accepts that the use of estimation in interim reports is likely to be greater than might be acceptable in full annual financial statements. The trade-off between relevance and reliability, given that the whole point of interim reports is rapid and timely information, is likely to lead to a different balance. Appendix 3 to the standard gives a number of detailed suggestions ("illustrative and not part of the standard") as to what this might mean. For example, the existence of an annual stock-take does not imply the need for interim stock-takes.

The IASB has issued IFRIC 10, "Interim Financial Reporting and Impairment," to deal with a typically obscure point of detail relating to impairment losses recognized in interim financial statements. The essential points are:

- An entity shall not reverse an impairment loss recognized in a previous interim period with respect to goodwill.
- An entity shall not extend this consensus by analogy to other areas of potential conflict between IAS 34 and other standards.

It should be noted that the reversal of impairment losses under IFRS GAAP is not necessarily forbidden in the general case.

RESTATEMENT OF PREVIOUSLY REPORTED INTERIM PERIODS

In general, IAS 8 will apply (see Chapter 6). IAS 34, paragraph 43, states that a change in accounting policy, other than one for which the transition is specified by a new standard or interpretation, should be reflected by:

1. Restating the financial statements of prior interim periods of the current financial year and the comparable interim periods of prior financial years that would be restated in the annual financial statements under IAS 8; or

2. When it is impractical to determine the cumulative effect of the new policy, as at the beginning of the financial year, adjusting the financial statements of prior interim periods of the current financial year and comparable interim periods of prior financial years to apply the new policy prospectively from the earliest date practicable.

The effect of this is to require that the change in accounting policy be applied retrospectively, or if that is not practicable, that it be applied prospectively from no later than the beginning of the financial year.

APPLYING THE RECOGNITION AND MEASUREMENT PRINCIPLES

IAS 34 contains an appendix, which gives a large number of examples of applying the principles of the standard. This appendix is only "illustrative" and not part of the standard. Many of the illustrations, paragraphs 12-22, relate to income taxes and discuss the application of the basic requirement to use the estimated weighted average annual effective tax rate expected for the full financial year. The examples are detailed and should be read in full by those seeking to apply IAS 34 in a complex scenario.

To reflect the nuances of difficulty at a more general level, we reproduce here just two of the examples given (IAS 34, Appendix B, pars. 5–7):

- *Year-End Bonuses.* The nature of year-end bonuses varies widely. Some are earned simply by continued employment during a time period. Some bonuses are earned on the basis of a monthly, quarterly, or annual measure of operating result. They may be purely discretionary, contractual, or based on years of historical precedent. A bonus is anticipated for interim reporting purposes if, and only if, (a) the bonus is a legal obligation, or past practice would make the bonus a constructive obligation for which the entity has no realistic alternative but to make the payments, and (b) a reliable estimate of the obligation can be made. IAS 19, "Employee Benefits," provides guidance.
- *Contingent Lease Payments.* Contingent lease payments can be an example of a legal or constructive obligation that is recognized as a liability. If a lease provides for contingent payments based on the lessee achieving a certain level of annual sales, an obligation can arise in the interim periods of the financial year before the required annual level of sales has been achieved, if that required level of sales is expected to be achieved and the entity, therefore, has no realistic alternative but to make the future lease payment.

It is interesting to observe the strong emphasis on the balance sheet elements in the above arguments—the focus is on the existence and measurement of obligations (liabilities), not on the usage or consumption of resources (expenses). This is consistent with the general approach taken in the IASB Framework (see Chapter 2).

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CHAPTER 28
PROPERTY, PLANT, AND EQUIPMENT

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OVERVIEW

The accruals (matching) convention requires that fixed (non-current) assets with a finite useful life should be gradually expensed over that life, in a manner such that annual expenses are pro rata with annual benefits. This process is known as *depreciation*.

IASB GAAP come from a variety of sources. The key relevant standards are:

- IAS 16, "Property, Plant, and Equipment"
- IFRS 3, "Business Combinations" (regarding goodwill)
- IAS 36, "Impairment of Assets"
- IAS 38, "Intangible Assets"

This chapter deals fully with IAS 16.

BACKGROUND

Assets have already been defined, as discussed in Chapter 2, as follows (Conceptual Framework, par. 4.4).

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

Assets are divided into fixed assets and current assets. The IAS terms are *non-current assets* and *current assets*, respectively. The distinction is formally defined in IAS 1 (par. 66).

An asset should be classified as a current asset when it:

1. Is expected to be realized in, or is intended for sale or consumption in, the entity's normal operating cycle; and
2. Is held primarily for the purpose of being traded;
3. Is expected to be realized within 12 months after the balance sheet date; and
4. Is cash or a cash equivalent (as defined by IAS 7, "Cash Flow Statements"), unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the balance sheet date.

All other assets should be classified as non-current assets.

The definition of non-current assets is often misunderstood. A non-current asset is not an asset with a long life. The essential criterion is the *intention* of the owner, the intended *use* of the asset. A non-current asset is an asset that the firm intends to use within the business, over an extended period, in order to assist its daily operating activities. A current asset, on the other hand, is usually defined in terms of time. A current asset is an asset likely to change its form, that is, likely to undergo some transaction, within 12 months.

→ **PRACTICE POINTER:** Consider two firms, A and B. Firm A is a motor trader. It possesses some motor vehicles that it is attempting to sell, and it also possesses some desks used by the sales staff, management, and so on. Firm B is a furniture dealer. It possesses some desks that it is attempting to sell, and it also possesses some motor vehicles used by the sales staff and for delivery purposes. In the accounts of A, the motor vehicles are current assets and the desks are non-current assets. In the accounts of B, the motor vehicles are non-current assets and the desks are current assets. Note incidentally that a fixed asset that, after several years' use, is about to be sold for scrap, remains in the fixed asset part of the accounts even though it is about to change its form.

The crucial difference between IASB GAAP and U.S. GAAP is that IASB GAAP permit the upward revaluation of depreciable and non-depreciable non-current assets, whereas U.S. GAAP do not. U.S. GAAP also allow no distinction between investment properties and other properties.

PRINCIPLES OF ACCOUNTING FOR DEPRECIATION

The first major problem with depreciation, perhaps surprisingly, is to agree on what it is, and what it is for. The generally agreed view nowadays is that it is in essence a straightforward application of the matching, or accruals, convention. With a non-current asset, the benefit from the asset is spread over several years. The matching convention requires that the corresponding expense be matched with the benefit in each accounting period. This does not simply mean that the total expense for the asset's life is spread over the total beneficial life. It means, more specifically, that the total expense for the asset's life is spread over the total beneficial life *in proportion to the pattern of benefit*. Thus, to take a simple example, if a non-current asset gives half of its benefit, or usefulness, in year 1, one-third in year 2, and one-sixth in year 3, and the total expenses arising are $1,200, then the matching convention requires the charging of $600 in year 1, $400 in year 2, and $200 in year 3, in the annual profit calculation. This charge is known as the *depreciation charge*.

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In order to calculate a figure for this charge, it is necessary to answer four basic questions:

1. What is the cost of the asset?
2. What is the estimated useful life of the asset to the business? (This may be equal to, or may be considerably less than, its technical or physical useful life.)
3. What is the estimated residual selling value ("scrap value") of the asset at the end of the useful life as estimated?
4. What is the pattern of benefit or usefulness derived from the asset likely to be (not the *amount* of the benefit)?

It is perfectly obvious that the second, third, and fourth of these involve a good deal of uncertainty and subjectivity. The "appropriate" figures are all dependent on future plans and future actions. It is important to realize that even if the first figure, the cost of the fixed asset, is known precisely and objectively, the basis of the depreciation calculation as a whole is always uncertain, estimated, and subjective. The estimates should, as usual, be reasonable, fair, and prudent (whatever precisely this implies).

But the first figure is often not at all precise and objective, for several reasons.

→ **PRACTICE POINTER:** Problems in establishing a "cost" figure for a non-current asset include the following:

1. Incidental expenses associated with making the asset workable should be included, for example, installation costs carried out by the business's own staff, probably including some overhead costs.
2. The non-current asset may be constructed within the business by its own workforce, giving rise to all the usual costing problems of overhead definition and overhead allocation.

3. Interest on related borrowing during the construction process may, or may not, be capitalized (see Chapter 7, "Borrowing Costs").

4. Depending on the accounting policies used by the firm generally, the "basic" figure for the fixed asset may be revalued periodically. Additionally, if land is not depreciated but the building on the land is, then this requires a split of the total cost (or value) figure for the land and buildings together into two possibly somewhat arbitrary parts.

5. Major alterations/improvements may be made to the asset part way through its life. If these appear to increase the benefit from the asset over the remaining useful life, and perhaps also to increase the number of years of the remaining useful life, and are material, then the costs of these improvements should also be capitalized (i.e., treated as part of the non-current asset from then on). Maintenance costs, however, are "running" expenses and should be charged to the income statement as incurred. In practice, this distinction can be difficult to make.

The total figure to be depreciated, known as the *depreciable amount*, will consist of the cost of the asset less the scrap value. This depreciable amount needs to be spread over the useful life in proportion to the pattern of benefit. Once the depreciable amount has been found, with revision if necessary to take account of material improvements, several recognized methods exist for spreading, or allocating, this amount to the various years concerned. The more important possibilities are outlined below. It is essential to understand the implicit assumption that each method makes about the pattern of benefit arising and therefore about the appropriate pattern of expense allocation.

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Methods of Calculating Depreciation

Straight-Line Method

The depreciable amount is allocated on a straight-line basis, that is, an equal amount is allocated to each year of the useful life. If an asset is revalued or materially improved, then the new depreciable amount will be allocated equally over the remaining, possibly extended, useful life.

Illustration of Straight-Line Method

Using the straight-line method, calculate the annual depreciation charge from the following data.

Cost ("basic" value figure)	$12,000
Useful life	4 years
Scrap value	$2,000
Annual charge	= ($12,000 – $2,000)/4
	= $2,500

This is by far the most common method. It is the easiest to apply, and also the preparation of periodic (e.g., monthly) accounts for internal purposes is facilitated. This method assumes, within the limits of materiality, that the asset is equally useful, or beneficial, each year. Whether this assumption is as frequently justified as the common usage of the method suggests is an open question.

Reducing-Balance Method

Under this method, depreciation each year is calculated by applying a constant percentage to the net book value (NBV) brought forward from the previous year. (Note that this percentage is based on the cost less depreciation to date.) Given the cost (or valuation) starting figure, and the useful life and "scrap" value figures, the appropriate percentage needed to make the net book value at the end of the useful life exactly equal to the scrap value can be found from a formula:

where d is the depreciation percentage, n is the life in years, S is the scrap value, and C is the cost (or basic value).

This formula is rarely used. In practice, when this method is used a standard "round" figure is usually taken, shown by experience to be vaguely satisfactory for the particular type of asset under consideration. Notice, incidentally, that the formula fails to work when the scrap value is zero, and produces an extreme and possibly distorted allocation of expense when the scrap value is very small.

Illustration of Reducing-Balance Method

Using the data of the previous illustration and assuming a depreciation percentage of 40%, calculate the depreciation charge for each of the 4 years using the reducing balance method.

Year 1	Cost	$12,000
	Depreciation 40%	4,800
Year 2	NBV	7,200
	Depreciation 40%	2,880
Year 3	NBV	4,320
	Depreciation 40%	1,728
Year 4	NBV	2,592
	Depreciation 40%	1,037
	NBV	$1,555

If the estimated scrap value turns out to be correct, then a "profit" on disposal of $445 would be recorded also in year 4. This is an example of a reducing-charge method, or of an accelerated depreciation method. The charge is highest in the first year and gradually reduces over the asset's life.

Several arguments can be advanced for preferring this approach to the straight-line method, at least in theory, as follows:

1. It better reflects the typical benefit pattern, at least of some assets.
2. It could be argued that, where the pattern of benefit is assumed to be effectively constant, the appropriate "expense," which needs to be correspondingly evenly matched, is not the pure depreciation element, but the sum of:
   (a) The pure depreciation element, and
   (b) The maintenance and repair costs.

Because (b) will tend to increase as the asset gets older, it is necessary for (a) to be reduced as the asset gets older, in the hope that the total of the two will remain more or less constant. This may be a valid argument in the most general of terms, but of course there is no reason why an arbitrary percentage applied in one direction should even approximately compensate for flexible and "chancy" repair costs in the other.

3. It better reflects the probable fact that the value (i.e., the market or resale value) of the asset falls more sharply in the earlier years. This argument, often advanced, is questionable in principle. Depreciation is concerned with appropriate allocation of expense, applying the matching convention. It is not concerned with an annual revaluation of the fixed assets, so whether or not a particular method is good or bad from this viewpoint is, or should be, irrelevant. As long as the original estimate of future benefit is still valid, the fact that current market value is small, at an intermediate time, is not of concern.

A particular variant found in practice in some countries is known as the double-declining balance method. This involves calculating the appropriate "straight line" depreciation percentage, then doubling it and applying the resulting percentage on the reducing balance basis.

Sum-of-the-Digits Method

The sum-of-the-digits method is another example of a reducing-charge method. It is based on a convenient "rule of thumb" and produces a pattern of depreciation charge somewhat similar to the reducing-balance method.

Using the same figures as before, the 4 years weights of 4, 3, 2, and 1, respectively, are given and the total of weights is calculated. In general terms, it is the n years weights of $n, n-1, \ldots, 1$, respectively, and sum the total weights, the sum being $n(n+1)/2$. The depreciable amount is then allocated over the years in the proportion that each year's weighting bears to the total.

Illustration of Sum-of-the-Digits Method

Using the data in the previous illustrations gives the following figures:

4 + 3 + 2 + 1 = 10 (the "sum" of the "digits")

Depreciable amount = $12,000 – $2,000 = $10,000

Depreciation charges are:

Year		
	1	4/10 × 10,000 = $4,000
	2	3/10 × 10,000 = $3,000
	3	2/10 × 10,000 = $2,000
	4	1/10 × 10,000 = $1,000

This gives NBV figures in the balance sheet of $8,000, $5,000, $3,000, and $2,000 for year ends 1-4, respectively.

Output or Usage Method

The output or usage method is particularly suitable for assets where the rate of usage or rate of output can be easily measured. For example, a motor vehicle might be regarded as having a life of 100,000 miles, rather than a life of 4 years. The depreciable amount can then be allocated to each year in proportion to the recorded mileage, for example, if 30,000 miles are covered in year 1, then 3/10 of the depreciable amount will be charged in year 1. The life of a machine could be defined in terms of machine hours. The annual charge would then be:

$$\text{Depreciable amount} \times \frac{\text{Machine hours used in the year}}{\text{Total estimated life in machine hours}}$$

Revaluation or Arbitrary Valuation

The revaluation or arbitrary valuation approach is occasionally used with minor items such as loose tools. An estimated or perhaps purely arbitrary figure for the value of the items (in total) is chosen at the end of each year. Depreciation is then the difference between this figure and the figure from the previous year. Strictly, of course, this is not a method of depreciation at all, but a lazy alternative to it.

All of the above methods can be criticized on the grounds that they ignore the fact that the resources "tied up" in the fixed asset concerned have an actual cost to the business in terms of interest paid, or an implied (opportunity) cost in terms of interest foregone. This could well be regarded as an essential expense that should be matched appropriately against the benefit from the asset. The "actuarial" methods that attempt to take account of interest expense are complicated to apply and in financial accounting are hardly ever used.

OBSERVATION: The process of depreciation calculation is not designed to produce balance sheet numbers that are either particularly meaningful or particularly useful as measurements of value; in fact, they are measurements of unexpired costs.

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It must be remembered that depreciation is a process of matching expenses in proportion to benefits. Given that the depreciable amount has been agreed, the annual charge is based on actual or implied assumptions as to the pattern of benefit being derived, and nothing else. In simple bookkeeping terms, all that is happening is that a transfer is being made from the non-current assets section in the balance sheet to the expenses section in the income statement. It is the expense that is being positively calculated, not the reduction in the asset figure. It follows from this that:

1. The asset figure for an intermediate year has no very obvious or useful meaning. It can only be defined in a roundabout way. For example, under historical cost accounting, it is the amount of the original cost not yet deemed to have been used or not yet allocated. This intermediate figure is often called "net book value," but it is *not* a value at all within the proper meaning of the word.

2. Depreciation has nothing to do with ensuring that the business can "afford" to buy another asset when the first one becomes useless. This is true even if we ignore the likelihood of rising price levels. Depreciation does not increase the amount of any particular asset, cash or otherwise.

3. However, depreciation, like any other expense figure, does have the effect of retaining *resources* (or total assets) in the business. By reducing profit, we reduce the maximum dividend payable (which would reduce resources) and, therefore, increase the "minimum resources remaining" figure. This is, in fact, a particular illustration of the idea of capital maintenance discussed in Chapter 10.

IASB GAAP

An early standard on depreciation, IAS 4, has long been withdrawn. IASB GAAP on depreciation are now contained in IAS 16, "Property, Plant, and Equipment," IFRS 3, "Business Combinations," and IAS 38, "Intangible Assets."

PROPERTY, PLANT, AND EQUIPMENT

IASB GAAP for the accounting treatment of property, plant, and equipment is provided by IAS 16. Originally issued in 1981, IAS 16 was revised in 1993, effective January 1, 1995, and revised again in 1998, effective accounting periods beginning on or after July 1, 1999. The 1998 changes were essentially concerned with consequential amendments arising from the issue of IAS 36, "Impairment of Assets" (see Chapter 20), and IAS 37, "Provisions, Contingent Liabilities, and Contingent Assets" (see Chapter 29). Further amendments have been made regularly.

The standard notes that the general definition and recognition criteria for an asset given in the "The Conceptual Framework for Financial Reporting" (discussed in Chapter 2), must be satisfied before IAS 16 applies. Subject to that, IAS 16 applies to accounting for all property, plant, and equipment except when another IAS requires or permits a different accounting treatment (par. 2).

There are, in fact, a number of exclusions. It is explicitly stated (par. 3) that IAS 16 does not apply to biological assets related to agricultural activity (to which IAS 41 applies; see Chapter 35), nor to mineral rights and mineral reserves, such as oil, natural gas, and similar non-regenerative resources. However, it does apply to property, plant, and equipment used to develop or maintain these activities or assets but separable from those activities or assets. IAS 16 does not apply to property, plant, and equipment classified as held for sale in accordance with IFRS 5, "Non-Current Assets Held for Sale and Discontinued Operations" (see Chapter 27). IAS 16 also does not apply to the recognition and measurement of "exploration and evaluation assets" as defined in IFRS 6, "Exploration for and Evaluation of Mineral Resources" (see Chapter 37).

An enterprise applies IAS 40, "Investment Property," rather than IAS 16, to its investment property (see Chapter 25). With effect from January 1, 2009, IAS 40 applies to property being constructed or developed for future use as an investment property. IAS 40 also applies to existing investment property being redeveloped for future continued use as investment property.

In 2009, IFRIC 18, "Transfers of Assets from Customers," was issued, applying prospectively to transfer of assets received from customers after July 1, 2009. This addresses the requirements for agreements in which an entity receives an item of property, plant, or equipment from a customer and is required to use that item either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services (such as a supply of electricity, gas, or water).

If the item meets the definition of an asset in the IASB's "Framework for the Preparation and Presentation of Financial Statements," the entity recognizes the asset as property, plant, and equipment. The cost of the asset on initial recognition is its fair value. The fair value of the total consideration received or receivable (including the fair value of the asset) is allocated to each service or supply and the revenue for each service or supply is recognized in accordance with IAS 18, "Revenue." Note that IFRIC 18 is withdrawn, effective from the date of adoption of IFRS 15 (see Chapter 32).

In June 2014, effective from 1 January 2016, IASB issued amendments to IAS 16 and to IAS 41, "Agriculture," relating to "bearer plants" (defined below). In simple terms, a vine, which "bears" the growing grapes, is an example of a bearer plant. The vine is a fixed (non-current) asset, and the grapes are a current asset (and are agriculture produce). The new requirements transfer the treatment of the bearer plants, but not of the crops growing on them, from IAS 41 to IAS 16. This significantly changes the measurements methods available. See also Chapter 35, "Agriculture," which discussed this in detail with some observations.

If any other IAS permits a particular approach to the initial recognition of the carrying amount of property, plant, and equipment, then that standard will prevail regarding this initial carrying value, but IAS 16 would then apply to all other aspects, including depreciation. An example of this would be IFRS 3, "Business Combinations," which requires property, plant, and equipment acquired in a business combination to be measured initially at fair value (see Chapter 8).

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