Solutions manual

to accompany

Contemporary issues in accounting

2nd edition

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WILEY

Chapter 2: The *Conceptual Framework of Financial Reporting*

Contemporary issue 2.1

No need for prudence

Questions

1. **Do you agree or disagree that re-including prudence in the *Conceptual Framework* is a bad idea? Give reasons for your answers.**
2. **How would you choose to measure the liability in the example if:**
   - **(a) the framework did include the definition of prudence (as defined in the *Proposed Framework*)**
   - **(b) no reference to prudence was included in the conceptual framework**
   - **(c) prudence was included but was defined as asymmetrical prudence?**
3. **Reflecting on your answers in question 2, what impact would these alternatives have on the quality and usefulness of financial reports?**

1. *For background:* the definition of prudence in the *Proposed Framework* is 'the exercise of caution when making judgements under conditions of uncertainty'(2.18). This is interpreted as 'cautious prudence — being equally cautious when making judgements about any items, 'without needing to be more cautious in judgements relating to gains and assets than those relating to losses and liabilities' rather than asymmetric prudence. The IASB argues that this is consistent with neutrality; 'A neutral depiction is without bias in the selection or presentation of financial information (2.17).'

It will be a personal position as to whether or not students agree with re-including prudence. Some arguments for/against would be:

- Unnecessary to include as professional judgment would require care/caution to be applied where there is uncertainty even if prudence was not explicitly included in the framework.
- Inclusion causes more confusion as there can be different interpretations, especially if guidance lacking.
- Is useful to include as emphasises need (and therefore an obligation/duty) to especially take care in conditions of uncertainty.
- Could argue that unnecessary for application, however as many constituents argued for its reintroduction, a compromise made to assist in acceptance of changes to the framework (so political reason).

2. Students should recall that relevance and faithful representation are the two fundamental characteristics that information needs to have to be useful for users. So these need to be considered. As noted above prudence supports neutrality which is part of a faithful representation. A faithful representation requires representation to faithfully what it purports to represent and to be complete, neutral and free from error. This also requires a description of what the number represents.

There are no correct answers to (a) to (c) below as this is open to interpretation (and balancing the fundamental qualitative characteristics) but possible choices are provided.

2. (a) Could argue $250. This takes into account all of the information known, but is not the lowest amount (so a cautious approach).

2. (b) Could argue either $100, as this the most likely amount, or the expected value of $250, as this factors in all the known information objectively.

However it could be argued I would argue that the same measures would be used for both (a) and (b) as prudence in the *Proposed Framework* is supporting neutrality.

2. (c) As focus is on ensuring liabilities not understated then could argue $500, as with any other measure there is the possibility that liability is understated.

3. With these small numbers in the example, it probably would not impact on quality or usefulness. However if these were in millions and larger variations, then they could be material. If for example, included 'additional' $400 million in expenses and provisions, when this is unlikely to occur, this could be argued to be distorting the financial positon/performance.

Contemporary issue 2.2

New lease accounting to have big impact

Questions

1. **Consider the definitions of an asset and liability in the *Proposed Framework*. Would a 5-year lease for land meet these definitions?**
2. **The extract discusses the fact that these changes reflect the way in which accounting is moving — that is, towards putting all assets and liabilities on the balance sheet. What reasons could there be for this move? Is this consistent with the approach in the *Proposed Framework*? Given the identified impact on key company ratios, do you believe this approach is justified?**

1. *Student should apply the definitions of an asset and a liability from the Proposed Framework:*

In the *Proposed Framework* an asset is:

- An asset is a present economic resource controlled by the entity as a result ofpast events (para 4.5). Further an economic resource is defined in para 4.6 as 'a right that has the potential to produce economic benefits'.

Therefore would meet definition as: it is an economic resource. The use of the land can result in benefits/cash flows and constitutes via the lease contract a right. Paragraph 4.8 states:

- 4.8 Rights that constitute economic resources may take the following forms:
  (a) rights established by contract, legislation or similar means, such as:
  (ii) rights over physical objects, such as property, plant and equipment or inventories. Such rights may include ownership of a physical object, the right to use a physical object or the right to the residual value of a leased object.

Control would be established as given the contract the lessee can obtain the benefits from using the asset.

Past event: would be lease contract that gave rise to lessee having right of use of asset and controlling and accessing benefits.

In the *Proposed Framework* a liability is:

- A liability is a present obligation of the entity to transfer an economic resource as a result of past events (4.24).

The transfer or economic resources would be the meeting of lease payments).

Present obligation:under leasing contract would assume have legal obligation to make payments.

Past event: would be lease contract that gave rise to obligation.

Note: the previous accounting standard on leases, AASB 117 *Leases*, overrode the general recognition criteria for liabilities and requires liabilities in relation to finance leases to be recognised. A finance lease is a lease in which substantially all of the risks and rewards incidental to ownership have been transferred from the lessor (legal owner of the property) to the lessee (one who is using the property) (AASB 117 para 4). Given that land has an indefinite life a 5 year lease of land would be classified as an operating lease and would not give rise to an asset or liability. Under the new leasing standard, AASB 16,these changes and an asset and a liability would be recognised.

2. Reasons towards the move towards putting all assets and liabilities on the balance sheet would be:

- Based on principles & objectives of financial reporting: To be consistent with the conceptual framework all items that meet the definition and recognition criteria of assets and liabilities should be included on the balance sheet. Also to be complete and so representationally faithful would argue that need to include all elements. Surely information about the assets and liabilities of an entity would be relevant to users.
- Improves comparability as does not distinguish on form or arbitrary rules but reflects economic substance. For example, under the previous lease accounting 2 entities could have identical items of land – one entity owns and one leases (as operating lease). The different accounting treatment would result in one entity including an asset but the leasing one not. This would distort ratios such as return on assets etc. and make comparison difficult.
- Reduces opportunities to structure transactions on order to reflect a particular financial position (this could include maintaining certain ratios). If all assets and liabilities meeting the recognition criteria are required to be included on the balance sheet then this limits the ability of entities to choose or plan transactions to avoid including these on their balance sheet or in particular to 'hide' obligations/ /commitments. Under the current leasing arrangements company may decide to lease land rather than purchase (even those costs and commitments may be relatively equal) as leasing will avoid the recognition of the lease liability and asset. It could be argued that the use of special purpose entities by Enron which were not required to be included on the balance sheet and were used to hide debt is an example of structuring transactions to reflect a particular financial position.

Cleary including all assets and liabilities on the balance sheet would impact on key financial ratios. Whilst it could be argued that this could disadvantage some companies (for example, if they are now required to include such assets and liabilities this could mean that they may breach debt covenant ratios and incur costs unless they are able to renegotiate debt terms/covenants). However an alternative argument is that if all assets and liabilities are included then this provides a more complete and representationally faithful view of the financial position and hence the ratios are more 'accurate' and useful.

Contemporary issue 2.3

Intangible assets hold real value

Questions

1. **The extract discusses the ban from including most intangible assets in the balance sheet unless acquired. Consider whether some, or all of such 'banned' intangibles would meet the definition of an asset and criteria for recognition in either the *Conceptual Framework* or the *Proposed Framework*.**
2. **Do you believe the inconsistent treatment between purchased versus internally generated items is justified?**
3. **If the financial statements are 'leaving out' most of the important assets, what does this imply for the usefulness of financial statements for users?**

1. In the *Proposed Framework* an asset is:
   - An asset is a present economic resource controlled by the entity as a result ofpast events (para 4.5). Further an economic resource is defined in para 4.6 as 'a right that has the potential to produce economic benefits'.

Therefore such a banned intangible (e.g. an internally created brand, or customerlist) would normally meet definition as:
- It is an economic resource. The useof the brand can result in benefits/cash flows and the entity would have right.

Paragraph 4.8 states:
- 4.8 Rights that constitute economic resources may take the following forms:
  (a) rights established by contract, legislation or similar means, such as:
  (vi) intellectual property rights, for example, registered patents.
  (c) other rights that give the entity the potential to receive future economic benefits that are not available to all other parties, for example, rights to the economic benefits that may be produced by items such as know-how not in the public domain or by customer or supplier relationships. (see paragraph 4.20).

Control would be established. This could be via contract or legislation (e.g. registration of brand name) or as access to benefits determined by the entity.

The *Proposed Framework* states:
- 4.19 An entity has the ability to direct the use of an economic resource if it has the right to deploy that economic resource in its activities, or to allow another party to deploy the economic resource in that other party's activities.
- 4.20 Although control of an economic resource usually arises from legal rights, it can also arise if an entity has the present ability to prevent all other parties from directing the use of it and obtaining the benefits from the economic resource. For example, an entity may control know-how obtained from a development activity by having the present ability to keep that know-how secret.

Past event: would be activities of the entity that created the brand (or customer list).

Recognition criteria:

In the *Proposed Framework* recognition is specified in para 5.9. An item meeting the definition is recognised if such recognition provides users of financial statements with:
(a) Relevant information about the asset or the liability and about any income, expenses or changes in equity.
  - Cleary information about such intangibles would be relevant to users. Where there is some uncertainty about obtaining the benefits, then this would normally be reflected in the measurement (unless such low probability that may not be relevant).

(b) A faithful representation of the asset or the liability and of any income, expenses or changes in equity (extracts from para 5.9).
  - Given that to include in the statements (recognise) we need to place a $ amount against the item this could be more problematic.

The*Proposed Framework* discusses uncertainties (such as existence uncertainty, low probability and measurement uncertainty) and explains that such uncertainties may impact on relevance (and therefore impact on whether recognition criteria are met). The issue for most of these assets would relate to measurement uncertainly – how can these be measured-especially as by nature these are often unique and it is this uniqueness that gives value (e.g. Coca Cola brand). However it could be argued:

- that if there has been an 'offer' (or sales of similar assets if for example considering customer lists etc.) then this would provide a means of faithful representation.
- that a number of entities (such as BrandZ and Interbrand) do place values on such intangibles.

Thus, as long as assumptions and uncertainties disclosed, valuations could be made.

Therefore it could be argued that a number of these 'banned' intangibles would meet the definition of an asset and the recognition criteria in the *Proposed Framework*.

In the *Conceptual Framework* an asset is:

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

Again such a banned intangible (e.g. an internally created brand, or customer list) would normally meet definition as:

- Future economic benefits would be the right to use the assets/brands (and the cash that you obtain from these).
- Control would be established via contract or legislation (e.g. registration of brand name) or as access to benefits determined by the entity. The *Conceptual Framework* also states that:
    - Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definitionof an asset even when there is no legal control.
        - For example, know-how obtained from a development activity may meet the definition of an asset when,by keeping that know-how secret, an entity controls the benefits that areexpected to flow from it.
    - Past event: would be activities of the entity that created the brand (or customer list).

The *ConceptualFramework* states that:

- 4.38/83 An item that meets the definition of an element should be recognised if:
  (a) it is probable that any future economic benefit associated with the item will flow to or from the entity.
    - For the majority of such intangible, probability would be met (i.e. it would be more likely rather than less likely).

  (b) the item has a cost or value that can be measured with reliability.

Recall that reliability essentially equates to representational faithfulness. Therefore discussion above in relation to the equivalent recognition criteria in the *Proposed Framework* is relevant.

Therefore it could be argued that a number of these 'banned' intangibles would meet the definition of an asset and the recognition criteria in the *Conceptual Framework*

2. There is no correct answer here. Arguments for/against include:

- By failing to include such items, the financial reports are often omitting what are the most important assets/items to a company. This therefore reduces the usefulness of the financial reports.
- The incorporeal nature of some items such as (for items such as human capital, innovations) necessarily means that in many instances identifying these and deciding on what impact or significance they have or may have is inherently subjective. This could impact on the usefulness of any information provided.
- How would we measure some intangibles that are internally generated. These would be difficult to value (either in attributing costs or future economic benefits).
- Inclusion of such items may involve subjectively. Could this result comprising its usefulness or in difficultly auditing such information or provide directors or others with opportunities to bias results. This could impact overall on the usefulness of the financial reports.

It should be noted that IAS 38/AASB 138, para 128 *encourages* entities to provide a description of significant intangible assets that have not been recognised as assets due to failing the recognition criteria.

3. There are alternative views here. One is obviously that, as noted in 2, that by failing to include such items, the usefulness is reduced.

However, there are alternative views.

One view is it is necessary to restrict information in these reports to make these comparable, understandable and also auditable. The financial statements are not the only source of information about an entity, and all information about an entity (e.g. such things as the expertise of directors, future strategies) and not included in the financial statements (and related notes).

Given the subjectivity involved in including many of these items, and therefore the opportunity for 'earnings management'/management and distortion, including such items with at times relatively arbitrary measures, could actually impede usefulness. There is a need to balance the quality of the information with the range of information provided to ensure integrity of financial reports are maintained (and therefore can be 'trusted' by users).

Even if not recognised as assets in the statements, relevant information is not limited to these or to numbers. Information could be provided in narrative form (as the standard encourages) in the notes.

Review questions

2.1 What is a conceptual framework? (LO1)

A conceptual framework is defined in the text as a set of broad principles that provide the basis for guiding actions or decisions. An accounting conceptual framework can be described as: a coherent system of concepts that underlie financial reporting. As the *Conceptual Framework*states 'This *Framework* sets out the concepts that underlie the preparation and presentation of financial statements for external users' (A 25/para 1).

2.2 What is the difference between a conceptual framework and accounting standards? (LO1)

Essential points relate to:

- The conceptual frameworkprovides high level concepts such as definitions of elements of financial statements, qualitative characteristics the objective of general purpose financial reporting. Standards apply the concepts in specific situations—for example, accounting for financial instruments, leases and inventory.
- The standards setters base new accounting standards, and amendments to old, on the conceptual framework.
- Standards take precedence in the event of conflict as the *Conceptual Framework.* In Australia, the *ConceptualFramework* does not have legal force for reporting entities subject to the Corporations Law; accounting standards do. As para 2 states 'Nothing in this *Framework* overrides any specific Australian Accounting Standard'. However, concepts from the conceptual framework are included in new and reissued accounting standards. Therefore,where these concepts are embedded application is mandatory because these are included in accounting standards.

The differences are illustrated with the following examples.

- IAS 1/AASB 101 para 9outlines information about the purpose and elements included in a financial report:
  - Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity's:
    (a) assets;
    (b) liabilities;
    (c) equity;
    (d) income and expenses, including gains and losses;
    (e) contributions by and distributions to owners in their capacity as owners; and
    (f) cash flows.
  - This information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

- The *Conceptual Framework* (para. 4.4/49) provides definitions of basic elements to be included in the statement of financial position such as:
  (a) *An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.*

- Accounting standards provide *specific* requirements for a *particular* area of financial reporting. These are required to be complied with via corporations' law.
  - For example:
    - IAS 1/AASB 101 *Presentation of Financial Statements* specifies thatparticular assets or liabilities must be included in (as a line item in the front of the statement of financial position itself (such as intangibles).
  - AASB 102 *Inventories* (para. 9) specifies thatinventories *shall be measured at the lower of cost and net realisable value.*

2.3. Outline the technical benefits of a conceptual framework. What problems could occur if accounting standards were set without a conceptual framework?(LO5)

The technical benefits relate to improving how financial reporting works — either though improving quality, or accounting practice, via improving understanding. The *Conceptual Framework* outlines these under its purpose section (page A25).

(a) to assist the Board in the development of future IFRSs and in its review ofexisting IFRSs;
(b) to assist the Board in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financialstatements by providing a basis for reducing the number of alternativeaccounting treatments permitted by IFRSs;
(c) to assist national standard-setting bodies in developing national standards;
(d) to assist preparers of financial statements in applying IFRSs and in dealingwith topics that have yet to form the subject of an IFRS;
(e) to assist auditors in forming an opinion on whether financial statementscomply with IFRSs;
(f) to assist users of financial statements in interpreting the informationcontained in financial statements prepared in compliance with IFRSs; and
(g) to provide those who are interested in the work of the IASB withinformation about its approach to the formulation of IFRSs.

In the AASB *Framework*these are listed para. 1 (a) to (g).

The problems that could occur if standards set without a conceptual framework are:

- Inconsistencies between standards if different concepts/principles used to develop different accounting standards.
- Time frame for developing standards could be longer as would need to debate underlying principles/concepts each time newstandard developed/changed.

2.4 How can the conceptual framework help users and preparers understand accounting requirements and financial statements? (LO3)

The conceptual framework can assist users and preparers as:

- Accounting standards based on the conceptual frameworkshould be more consistent.
- Rationale for standards should be apparent as based on underlying concepts which are explicitly stated in the conceptual framework.

2.5 Why do accountants need to use a conceptual framework in the exercise of professional judgement? (LO5)

The definition in the text (Chapter 1) from the American Accounting Association defines professional judgment as:

> Professional judgment is a process used to reach a well-reasoned conclusion that is based on the relevant facts and circumstances available at the time of the conclusion. A fundamental part of the process is the involvement of individuals with sufficient knowledge and experience. Professional judgment involves the [clarification of issues and objectives, and the] identification, without bias, of reasonable alternatives; therefore, careful and [unbiased] consideration of information that may seem contradictory to a conclusion is key to its application. In addition, both professional scepticism and objectivity are essential to the process and to reaching an appropriate conclusion.

As the text notes:

- In applying the standards accountants 'need to be schooled in the framework to understand fully the particular requirements of standards'.
- It provides the concepts that underlie the estimate, judgments and models in the standards and so provides the basis for resolving accounting issues.
- Many of the concepts are embedded with accounting standards. Thus the underlying concepts need to be interpreted and used in applying accounting standards.
- Where no accounting standard exists for a particular/transaction or event then the concepts in the framework need to be considered and applied.

A simple example can relate to say the decision as to which measurement method to use, or whether an item is material. The judgment needs to consider the underlying concepts such as the objectives of financial reporting and the qualitative characteristics.

2.6 How is the decision usefulness approach reflected in the *Conceptual Framework*and the *Proposed Framework*?What type of decisions do users need to make? (LO3)

An essential point to note is that the conceptual framework is based on the decision usefulness approach to accounting theory. The outputs of the accounting system are inputs to user decision processes.

This emphasis is reflected both in the objective of general purpose financial reporting (this is to provide information … that is useful to ... in making decisions) and in the qualitative characteristics.

ParagraphQC1 of the *Conceptual Framework* defines qualitative characteristics as:

> The qualitative characteristics of useful financial information discussedin this chapter identify the types of information that are likely to be mostuseful to the existing and potential investors, lenders and other creditorsfor making decisions about the reporting entity on the basis ofinformation in its financial report (financial information).

Although all aim of all of the qualitative characteristics is to ensure that information is useful the one that best reflects the decision–usefulness approach in the conceptual framework is relevance.

The qualitative characteristic, relevance, is one of the qualities that should be reflected in the information provided by general purpose financial reports. Relevance is outlined in the *Conceptual Framework* (para. QC6) as:

> 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 advantageof it or are already aware of it from other sources.

Paragraph QC7 of the *Conceptual Framework* states:

> Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both.

You should see that this has two roles: predictive and confirmatory (or feedback) and that these are interrelated (refer QC8 to 10) and that the key quality required is that the information could change/influence decisions.

Prediction: Part of the definition of relevance focuses on accounting information as an input to user prediction models. Information may help to predict future earnings or cash flows from future dividends, for example.

*Confirmation (Feedback):*Part of the definition notes that information is also relevant if it plays a feedback or confirmatory role in the decision process.

Most descriptions of decision processes view decision makers as seeking information:

- to help predict the future values of variables of interest for a decision, for example future revenues and future costs. Information plays a predictive role. Information about past events is fed into a decision model to help predict future values of the variables of interest (part (a) of the definition); and
- for confirmation or feedback, to help monitor the outcomes of past decisions part (b) of the definition).

2.7 The *Conceptual Framework*(paragraph OB6) and the *Proposed Framework* (paragraph 1.6) states that 'general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need' (para. OB6).What information is not provided and why? (LO3)

As stated in the *Conceptual Framework*:

> IOB6 However, general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.
>
> OB7 General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity.
>
> OB8 Individual primary users have different, and possibly conflicting,information needs and desires. The Board, in developing financial reporting standards, will seek to provide the information set that will meet the needs of the maximum number of primary users. However, focusing on common information needs does not prevent the reporting entity from including additional information that is most useful to a particular subset of primary users.

There are a number of keylimitations and/or omissions to the information provided in the financial reports:

- Information on general contextual issues (such as economic conditions) is not included.
- Information is limited to common information needs; so is not tailored to individuals or even individual user groups, which may require information specific to their decisions.
- The financial reports do not provide future orientated information. Thefocus of information provided in the financial statements is on past performance/position, and while these can be used to make predictions, these in themselves are not future orientated.
- Non-financial information is also limited. Although limited non-financial information is provided, the main information in financial reports is financial. Relevant information is not limited to numbers. For example, if a technology company hires

> one of the best minds in the field, would that information is an important factor in making an informed decision about the company's future economic prospects? Or if a bioengineering company lost its most productive R&D scientist, might that information influence stakeholders' decisions? It should be noted, however, that in the annual reports (of which the financial statements and notes are a part) reviews by directors often provide some of this information (often required by corporations law), and many particularly larger companies voluntarily provide non-financial information about environmental and social performance.

Why is this information not provided?

There are alternative views, and also advantages and disadvantages, in providing such information. One view is that the role of accounting is limited in scope to financial issues and, hence, limited to largely financial information. Others would argue that given that accounting is about 'accountability' the scope and role of accounting should be broadened to reflect the wider accountabilities of corporations in particular, or even that limiting reporting to financial information is not providing the information required by decisions makers (users).

2.8 Identify the qualitative characteristics of financial information in the *Conceptual Framework/Proposed Framework*. How are these related to the objectives of general purpose financial reports? (LO3)

The *ConceptualFramework (Proposed Framework)* states that:

> QC 1/2.1 The qualitative characteristics of useful financial information discussed in this chapter identify the types of information that are likely to be most useful to the existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report (financial information).
>
> QC4/2.4 If financial information is to be useful, it must be relevant and faithfully represents what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely andunderstandable.

So the role of qualitative characteristics is to ensure that information provided to users has these qualities as they will help ensure that the information is useful to users. This is directly related to the objective of general purpose financial reports, which in the *ConceptualFramework/Proposed Framework*, is to provide informationthat is useful to range of users in making decisions.

The *ConceptualFramework/Proposed Framework* identifies 2 fundamental qualitative characteristics: relevance and faithful representation. To be useful information must have both of these. As the *ConceptualFramework* states:

> QC17/2.20 Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor

> an unfaithful representation of a relevant phenomenon helps users make good decisions.

It also identifies a number of enhancing qualitative characteristics (comparability, verifiability, timeliness and understandability) which increase the usefulness of information, Each of these qualitative characteristics is outlined in the *ConceptualFramework/Proposed Framework* and these outline qualitative characteristics with the usefulness and use of information by users.

For example the qualitative characteristic of timeliness states:

> QC29/2.33 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.

Students should recognise that there may be a need to balance these qualities and trade these off. For example:

- The cost of an item purchased 20 years ago is verifiable however, it may not be relevant. A more relevant measure (such as what it could be sold for now, or the cash flows it is expected to generate in the future) may be less verifiable.

This need to trade-off is explicitly recognised in the *Conceptual Framework/Proposed Framework:*

> QC34/2.37 Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximise another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying a new financial reporting standard may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for non-comparability.

It is importantto understand these qualitative characteristics because these factors should be a key part of consideration in the areas where accountants are required to exercise judgement (e.g.in relation to accounting policies,etc.).

2.9 Not all relevant and faithfully representative information will be included in financial reports due to the materiality aspect and cost constraint identified in the *Conceptual Framework*. Outline the materiality aspect and the cost constraint on the provision of information. Can you think of any problems in applying these? (LO4)

Materiality can be considered as aspect of relevance and material information is outlined in the *Conceptual Framework* as:

> QC11 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. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

The cost constraint is outlined as:

> QC35 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. There are several types of costs and benefits to consider...

Problems in applying would include:

- Both of these require judgement. This leaves open the possibility of different interpretations, which could cause inconsistencies, and also the opportunity for motivations such as self-interest to distort or bias this judgement. This inherent subjectivity involved in applying the cost constraint is recognised explicitly in the *Conceptual Framework* (see QC39).
- These decisions are made by the preparers of the financial reports and yet these constrain the information provided to users. For example, most of the costs of preparing reports are borne by preparers (and companies) yet the benefits are for users. However, the preparers weigh the costs to them against their perceptions of the benefits to users; is this a conflict of interest?

2.10 Distinguish between 'cautious' prudence and 'asymmetrical' prudence. Using an example, explain what is meant by prudence in the *Proposed Framework*. (LO4)

The IASB defines these terms as:

1. Cautious prudence: being equally cautious when making judgements about any items, 'without needing to be more cautious in judgements relating to gains and assets than those relating to losses and liabilities'.
2. Asymmetric prudence: being *more* cautious about certain items than others; 'a need for systematic asymmetry: losses are recognised at an earlier stage than gains are'. It distinguishes this from deliberate under- or overstatement of items to influence whether information is received favourably or unfavourably.

The difference in these definitions is essentially of focus and degree. Cautious prudence requires equal care/attention for all items. This reflects the IASB's assertion that cautious prudence is consistent with neutrality. Whereas asymmetric prudence requires a *higher* degree of care (circumspection) for particular items. This is usually associated with ensuring assets are *not* overstated and labilities *not* understated (as opposed to any intentional bias).

The definition of prudence in the *Proposed Framework* is 'the exercise of caution when making judgements under conditions of uncertainty'(2.18). Many items involve some degree of uncertainty and students may use different examples. These could include:

- Adjustments/allowances for bad or doubtful debts. These are made to ensure that assets (and revenues) are not overstated.
- Provisions are, by definition, liabilities where there is uncertainty about timing or amount.

2.11 What is the difference between recognition and disclosure in accounting? (LO4)

Recognition is the process of recording information about an element *in the body* (within a line item) of a financial statement (*Conceptual Framework*, paragraph 4.37). Disclosure normally means that information is included (disclosed) *either* in the body (within a line item) of a statement or in the notes.

> 4.37 Recognition is the process of incorporating in the balance sheet orincome statement an item that meets the definition of an element andsatisfies the criteria for recognition set out in paragraph 4.38. It involvesthe depiction of the item in words and by a monetary amount and theinclusion of that amount in the balance sheet or income statement totals.Items that satisfy the recognition criteria should be recognised in thebalance sheet or income statement. The failure to recognise such itemsis not rectified by disclosure of the accounting policies used nor by notesor explanatory material

The *Proposed Framework* confirms this:

> 5.2 Recognition is the process of capturing, for inclusion in the statement of financial position or the statement(s) of financial performance, an item that meets the definition of an element. It involves depicting the item (either aloneor as part of a line item) in words and by a monetary amount, and including that amount in totals in the relevant statement.

Students may also refer to para. 48 of AASB 101:

> 48. This Standard sometimes uses the term 'disclosure' in a broad sense, encompassing items presented in the financial statements. Disclosures are also required by other Australian Accounting Standards. Unless specified to the contrary elsewhere in this Standard or in another Australian Accounting Standard, such disclosures may be made in the financial statements.

The following illustrate the difference between recognition and disclosure and although we normally consider disclosure to mean either on the face of the reports or in the notes, in some cases disclosure will be restricted to the notes:

- A company may have a relatively small expense (e.g. for postage). This would meet the definition and recognition criteria of an expense and thus be recognised (included in expense on the face of the relevant statement). However, this item (postage expense) would not need to be separately disclosed.
- A company may have a relatively large expense (e.g. for cost of sales). This would meet the definition and recognition criteria of an expense and thus be recognised (included in expense in a line item in the relevant statement). However, as this item is material (users need to know about this) it is required to be disclosed. Hence, would need to disclose the amount for this expense separately, either in notes or as a separate line item on the frontof the relevant report.
- A company may have an item that meets the definition of a liability but not the recognition criteria (for example, has been found liable in a court case but the amount to be paid has not yet been determined and cannot be estimated). In such cases, the relevant standard, AASB 137, requires disclosure of the item. As this does not meet both the definition and recognition criteria, it cannot be included or disclosed on the face of the financial statements. However, information about this item would be disclosed separately in the notes.

2.12 Outline and contrast the recognition criteria for items in both the *Conceptual Framework* and the *Proposed Framework*. (LO4)

In the *Conceptual Framework* recognition is a two-stage process.

Firstly, the item must satisfy the definition of an element of the financial reports. Secondly, information about an element will be *recognised* in the financial reports if it satisfies certain recognition criteria (these relate to probability and reliable measurement).

To know how this works we must understand the recognition criteria. The *ConceptualFramework* states that:

> 4.38/83 An item that meets the definition of an element should be recognised if:
>
> (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
>
> (b) the item has a cost or value that can be measured with reliability.

Probability test:
In the *Conceptual Framework* the term 'probable' refers to 'the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity (para. 4.40/85). You need to consider the available evidence. In terms of probability levels, this is usually interpreted as saying that the chance of economic benefits arising, or of a disposition of economic benefits occurring, is more likely rather than less likely. Pierson (1988) interprets this to mean that the probability level must exceed.

Reliable measurement:
For an item to be recognised it is necessary that it possess a cost or other value that can be measured reliably. The qualitative characteristic 'faithful representation' has now replaced 'reliability' which was previously a separate qualitative characteristic. The *Framework* outlined reliability as:

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

Hence a measure that meets the qualitative characteristic of faithful representation could be presumed to meet this recognition criteria. The enhancing qualitative characteristic of verifiability would also improve the reliability of measures.

The appropriate measurement basis for assets and liabilities has not been addressed in the *Conceptual Framework*.

In the *Proposed Framework* recognition is specified in para 5.9. An item meeting the definition is recognised if such recognition provides users of financial statementswith:

> (a) relevant information about the asset or the liability and about anyincome, expenses or changes in equity and
> (b) a faithful representation of the asset or the liability and of any income,expenses or changes in equity (extracts from para 5.9).

This recognition criteria has no probability threshold. However, the *Proposed Framework* discusses uncertainties (such as existence uncertainty, low probability and measurement uncertainty) and explains that such uncertainties may impact on relevance (and therefore impact on whether recognition criteria are met).

The contrasts between the recognition criteria in these frameworks can be summarised as:

- The *Conceptual Framework* required all items (meeting definition), that were probable and could be measured reliability to be recognised (and the reverse, that if failed the recognition criteria- e.g. due to low probability – could not be recognised).
- The *Proposed Framework* links recognition explicitly to objective offinancial reporting and need to provide useful information. This means:
  - That recognition is entity specific as needs to consider context. As this states' What is useful to users depends on the item and the specific facts and circumstances (5.10)
  - There is no longer a 'specified' probability level that determines whether or not an item is recognised. The *Proposed Framework* explicitly states:

    > 5.18 Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or the liability may provide

relevant information, especially if the measurement of the asset or the liability reflects the low probability and is accompanied by explanatory disclosures.

However this does not mean that regardless of probability items will be recognised. It depends on if the information would be useful to users (refer para 5.19 which states:

- 'However, users of financial statements may, in some cases, not find it useful for an entity to recognise assets and liabilities with very low probabilities of inflows and outflows of economic benefits.'

Students should note that information about elements that are not recognised may be disclosed by way of notes to the reports (para. 4.4.3/5.11 in *Proposed Framework*), or may be recognised later if the recognition criteria are subsequently met.

2.13 Why is accounting said to be 'political' in nature? How can a conceptual framework help in the setting of accounting standards in a political environment? (LO5)

The political nature of accounting is due to the fact that accounting informationis used in, and influences, decisions.Thus, the accounting 'rules' determine what information is providedand therefore what information is used in decisions. Recall that the objective of financial reporting is to provide information useful to users in making economic decisions. If economic decisions change and are influenced by accounting then this means that accounting information has economic consequences (i.e. can result in transfers of wealth). Thus, people will try to influence the accounting rules (the accounting standard) to try to ensure that their own interests are met.

The claim is that theconceptual framework provides some defence against 'political interference' as the framework can be used to justify the choices/decisions made by accounting standard setters in determining accounting rules. Also, individuals arguing against standards will find this more difficult if their arguments are inconsistent with an agreed upon conceptual framework.

2.14 It is claimed by some that the reason for conceptual frameworks in accounting is to protect the accounting profession rather than improve accounting practice.Explain the basis for this claim. (LO5)

Students should note the following major points.

1. Accountants have a special status in society as a profession and this professional status is valuable. (In Australia, this is witnessed by the Royal Charter endowed on the Institute of Chartered Accountants, the media profile associated with the CPA program of the Australian Society of CPAs, and the professional monopoly (or almost) by the two major accounting bodies).
2. The hallmark of a profession is possession of a unique body of knowledge. However accountings knowledge base is problematic due to a range of factors. Loss of professional status means that the power, prestige, self-regulation and economic position of accountants are eroded.
3. As the ability of the accounting profession to retain legitimacy as a profession will be judged by society, in terms of the apparent coherence and theoretical defensibility of the profession's body of knowledge; hence the need for a conceptual framework (Hines, 1989).

According to this view, as put by Hines, the conceptual framework project is not about setting rules for accounting practice; rather, it is about legitimising the process by which accounting practice is done. That is, the accounting profession:

- does not really value a conceptual frameworkfor its potential technical benefits.
- does value the appearance of having a conceptual framework to claim a unique body of knowledge to maintain its professional status, associated privileges and power.

2.15 Some people argue that the conceptual framework is acceptable in theory but in practice it does not work. Explain possible problems with and criticisms of the current *Conceptual Framework* or *Proposed Framework*. Do you think these problems exist and criticisms are valid? (LO6)

The problems or criticisms are:

- Too ambiguous and open to interpretation. By definition a conceptual framework provides broad concepts and, thus, any conceptual framework often will be open to interpretation.If too rigid, then the anyconceptual framework would not be broad enough or flexible enough to deal with the wide range of transactions, events and issues related to financial reporting. However, this broadness also means it can lead to inconsistencies or lack of adequate guidance. Presumably this is why there are more detailed standards, and we need to think here about the stated purpose of the accounting conceptual framework. Its key purpose is to guide accounting standard setters and to provide guidance where there are no standards. Further in some areas (such as measurement choices) it has been argued there is little guidance provided by either of the exiting or proposed conceptual frameworks.
- It is too descriptive. This criticism argues that because much of the *ConceptualFramework* reflects historical accounting practice, rather than driving and informingaccounting practice, it merely codifies what is currently practiced. Whether you accept this criticism as valid or not will depend on your view of what accountingshould do, and especially in relation to the scope and purpose. An alternative view is that accounting practice has developed over time and it is reasonable to assume that much of current practice is ‘correct’.
- The meaning of faithful representation is problematic. This is expanded on in the answer to question 2.16.
- That inconsistency with accounting standards casts doubt upon the efficacy of the framework. Inconsistencies can be caused by:
    - Delays in revising the conceptual framework so standards are set that are inconsistent with an ‘outdated’ framework. This questions the need for a framework given that the key stated purpose is to provide basis for standards.
    - Standards issued prior to changes in the conceptual framework(and not yet revised).
    - Compromise due to political nature of accounting standard setting process and need to achieve acceptance.
    - Standards can include restrictions that are not embodied in the frameworks to balance potential costs and benefits, especially where perceived risk of opportunistic accounting. Examples of this include restrictions on recognition of certain intangible assets, which it is argued has led to accounting being in conflict with reality.

2.16 Explain why some people believe that the concept of faithful representation in the *Conceptual Framework* is incorrect. (LO7)

First students should consider the definition of this term in the *ConceptualFramework*.

Faithful representation:

> QC12 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 maximise those qualities to the extent possible.

This answer explains this rationale for those who believe that this is incorrectby considering the meaning of this term as it relates to different word views about the nature of accounting.

Alternative views of nature of accounting:

*Realist view:*assumes that an objective reality exists independently of the observer; the world of theory and reality are separate. This assumes that there is an objective reality that exists independently of our accounts of it. The task is to 'discover' and record what it is that objectively exists. This assumes that the observer is independent of the events observed (and vice versa), and that our theories about the world do not affect the observers or observations made. Our observations are objective—we merely see what is 'out there' to be discovered. In accounting, this view assumes that the transactions and events that accountants describe and report exist independently of the descriptions themselves.

Materialist or Social constructionist—this alternative view argues two points:

- Our accounts of reality act upon reality and come to form part of that reality; 'that our knowledge of the world is just as much an invention as it is a discovery'. Our accounts construct the reality that they purport to describe. Therefore, accountants are not impartial, value-free score-keepers — they are involved in constructing the financial reality of a reporting entity; and
- Once the account of reality is accepted, we act on that account. Our theories about the world come to control us as they exert an irresistible influence on our actions. (Students should refer to the discussion of the scorers in the football game that is set out in the topic overview.)

View reflected in the representational faithfulness qualitative characteristic:

Representational faithfulness means the correspondence between a measure or description of events or objects and the events or objects themselves.

The definition assumes that the task of accounting is to faithfully represent, i.e. mirror economic transactions and events. The concept of representational faithfulness implies the assumption of 'realism'.This implies that there is a reality that accountants can observe objectively/neutrally and faithfully describe — the realist view.

Whether or not the view of reality reflected in the representational faithfulness (realist view is the correct view:

Accounting cannot mirror transactions and events if there is not an objective social reality that is unaffected by our accounts of it. Those who believe in the alternative world view (materialist or social constructionist) would hence argue that concept of representational faithfulness is based on a flawed view of reality. The key point here is that financial reality, or financial 'facts' (such as profit, liquidity, asset levels) do not exist independently of our measures of them. Accounting measures are not like natural phenomena (the sun, the moon etc.) that are there to be simply discovered. The problem is the numbers we report are not representations of objects. Accounting measures only arise via application of various rules and choices. Descriptions of abstractions such as net profit or financial position do not exist independently of our measures of them. In this way, accountants can be said to construct financial reality. See the example in the text in relation to different measures and different resulting profit figures.

2.17 Outline reasons why there may be inconsistencies between the *Conceptual Framework* (or *Proposed Framework*) and accounting standards. (LO8)

Inconsistencies can be caused by:

- Delays in revising the conceptual framework so standards are set that are inconsistent with an 'outdated' framework. This questions the need for a framework given that the key stated purpose is to provide basis for standards.
- Standards issued prior to changes in the conceptual framework(and not yet revised).
- Compromise due to political nature of accounting standard setting process and need to achieve acceptance.
- Standards can include restrictions that are not embodied in the frameworks to balance potential costs and benefits, especially where perceived risk of opportunistic accounting. Examples of this include restrictions on recognition of certain intangible assets, which it is argued has led to accounting being in conflict with reality.

2.18 Identify the characteristics of heritage assets. Would these characteristics preclude recognition as an asset, if applying the definition and recognition criteria in the *Conceptual Framework* (or *Proposed Framework*)? (LO8)

As outlined in section2.8 of the text many heritage assets have the following characteristics:

(a) their value in cultural, environmental, educational and historical terms is unlikely to be fully reflectedin a financial value based purely on a market price;
(b) legal and /or statutory obligations may impose prohibition or severe restrictions on disposal by sale;
(c) they are often irreplaceable and their value may increase over time even if their physical conditiondeteriorates; and
(d) it may be difficult to estimate their useful lives, which in some cases could be several hundred years.(IPASB, 2016).

In the *Conceptual Framework* an asset is:

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

An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
(b) the item has a cost or value that can be measured with reliability.

The *Conceptual Framework* is aimed at for profit entities and the discussion concerning what comprise 'economic benefits'reflects this by stating that 'The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity' (4.8).

Whilst some heritage assets *may* generate cash flows (and therefore could meet the definition) it is likely that for many the benefits derived are not related to cash flows.

Even for those heritage assets that do generate cash flows, there may also be problems with:

- Establishing control. Entities managing such assets often have restrictions placed on how they can be used, if they can be sold etc. and the entity may not be allowed to regulate or deny access to these assets.
- Reliable measurement also may be problematic (particularly if unique, so no market price and /or acquired at no cost).

Given this in most cases it would be doubtful that heritage assets would meet the definition and/or recognition criteria in the IASB's *Conceptual Framework*.

It should be noted that the AASB has made inclusions in the *Conceptual Framework (*and in accounting standards) so that these can apply for not –for-profit entities. For example:

> Aus54.1 In respect of not-for-profit entities, whether in the public or private sector, the future economic benefits are also used to provide goods and services in accordance with the entities' objectives. However, since the entities do not have the generation of profit as a principal objective, the provision of goods and services may not result in net cash inflows to the entities as the recipients of the goods and services may not transfer cash or other benefits to the entities in exchange.

AASB 116 Property Plant & Equipment includes the following:

15. An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

> Aus15.1 Notwithstanding paragraph 15, in respect of not-for-profit entities, where an asset is acquired at no cost, or for a nominal cost, the cost is its fair value as at the date of acquisition.

In the *Proposed Framework* an asset is:

- An asset is a present economic resource controlled by the entity as a result ofpast events (para 4.5). Further an economic resource is defined in para 4.6 as 'a right that has the potential to produce economic benefits'.

The discussion, similar to that in the *Conceptual Framework*, focus on for-profit-entities and the ability to contribute to cash flows. Hence again whilst some heritage assets *may* generate cash flows (and therefore could meet the definition) it is likely that for many the nature of the benefits derived are not related to cash flows, and therefore such items would not meet the definition of an asset in the *Proposed Framework*. This definition also includes the requirement for the resource to be controlled. Further the recognition criteria requires that there be 'a faithful representation of the asset'. Again, as noted above, the nature of these assets may make a faithful representation in terms of $ amount (measurement) problematic.

Given that the focus of the IASB standards (and the underlying framework) are on for-profit entities it is not unexpected that the principles would not necessarily readily apply to not-for-profit and/or government entities.

Application questions

2.19 As a group, identify two or three general principles to help guide the making of more specific rules in relation to a particular area, context or task. For example:

- **it may be that a group of students is planning on sharing accommodation (such as an apartment)**
- **you may be required to undertake a group assignment.**

Once you have agreed on the two or three principles, use these to form more specific rules in relation to the context or task. Then consider the following questions:

(a) How easy was it to agree on the basic principles?
(b) Are all the rules consistent with these principles?
(c) Have any members interpreted the principles differently?
(d) How useful were the principles in helping establish more specific rules?
(e) Were there any problems with using principles as a basis for setting the rules?
(LO3)

There are no set answers here. You would expect that students have difficulty setting the initial principles. By attempting to apply these principles, it is likely that the original principles will be amended, or different interpretations allowed.

This should demonstrate a number of issues:

- The difficulty (and time required) in arriving at agreement.
- The fact that individuals will interpret statements of principles differently (perhaps in line with their own preferences, situation and experiences) even where other individuals have believed that the rules were clear.
- Once established, the principles do reduce time to agree on more specific rules and also are used to justify agreement/disagreement of differing interpretations.

2.20 Look at the accounting standards and then:
(a) find examples of how parts of the *Conceptual Framework* or *Proposed Framework*(e.g. the definitions, recognition criteria, qualitative characteristics) have been included in them
(b) identify any inconsistencies between the requirements in accounting standards and the *Conceptual Framework* or *Proposed Framework*. Why do you think these have occurred?
(LO3, LO4 and LO8)

(a) Students should be able to find numerous examples such as (these were as at time Sept 2017):

- IAS 8/AASB 108 Accounting Policies, Changes in Accounting Estimates and Errors includes criteria to change accounting policy,and the qualitative characteristics of relevanceand reliability (which includes representational faithfulness).
- IAS 38/AASB 138 Intangible Assets includes recognition criteria before an intangible asset can be recognised, identical to that in the *Conceptual Framework.*
- IAS 37/ AASB 137 Provisions, Contingent Liabilities and Contingent Assets includes the definition of a liability as per the *Conceptual Framework*.

(b) Two inconsistencies are:

- IAS 38/AASB 138 Intangible Assets does not allow the later recognition of items that have been expensed but now meet the definition and recognition criteria ofan asset. Yet the *Conceptual Framework*,para 4.42, states‘ An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 4.38 may qualify for recognition at a later date as a result of subsequent circumstances or events.’
- IAS 38/AASB 138 Intangible Assets does not allow recognition of some internally generated assets (such as brands etc.) even if these meet the definition and recognition criteria for an asset in the *Conceptual Framework.*
- IAS 37/ AASB 137 Provisions, Contingent Liabilities and Contingent Assets prohibits the recognition of contingent assets even if these meet the definition and recognition criteria for an asset in the *Conceptual Framework.*
- Note: There would at present be numerous inconsistencies with the *Proposed Framework* (e.g. definitions, recognition criteria) as the standards were written prior to this. However when the *Proposed Framework* is issued it is expected that the IASB will make adjustments, progressively, to a number of standards.

Students may identify other inconsistencies. Possible reasons for inconsistencies could be:

- Accounting standards originally evolved without *Framework*or prior to revisions in the *Framework*.
- Opposition to change by interest groups so compromises need to be made.
- Concern that any alternatives permitted would reduce consistency or provide opportunities for manipulation.

2.21 Find the comments letters received on a current exposure draft or proposal. (These can be found from the websites of most standard-setting organisations, such as IASB, AASB or FASB). Read a sample of comments from a range of respondents (e.g. from accounting bodies, industry, company or corporate bodies) and answer the following questions:
(a) Is there agreement among the various groups?
(b) If there are any concerns or objections, are they based on conceptual issues, practical issues or potential economic consequences? Does this vary among groups?
(c) Have any of the comments letters referred to the *Conceptual Framework*or *Proposed Framework*as a basis to support their views?
(d) Do the comments letters suggest that there is support for the *Conceptual Framework* or *Proposed Framework*?
(LO2)

No specific answers are provided here as this will depend on current exposure drafts and the nature of these as to comments and responses received. The following gives some issues to consider.

(a) If there is disagreement is this related to groupings (e.g. smaller reporting entities; not-for–profit; accounting firms versus academics).

(b) Again consider the nature and impact of proposed changes on the various groups — if economic consequences or impacts of changes vary across groups this is likely to influence reactions. You will often find a range of justifications — some will argue practical problems, others economic consequences, others conceptual issues (or a combination).

(c) Again this will depend on current exposure drafts and the nature of these as to comments and responses received. Although not an Exposure draft an interesting issue relates to a Discussion paper issued in March 2017 Disclosure Initiative—Principles of Disclosure. This asks for comments about various ways to set and include disclosure principles (e.g. separate standards, non-mandatory guidance or amendments to standards). A number of comments (see comments from The Institute of Certified Public Accountants in Ireland and CPA Australia) which specifically consider relationship/role between the conceptual framework and proposed options. For example, the

When viewed as a whole the IFRS framework remains a principles based framework but disclosures contained within these [standards] remain largely prescriptive and to some degree, undermine the principles based approach to IFRS (page 12).

(d) Again this will depend on current exposure drafts and the nature of these as to comments and responses received. However, think about the following question — are they supporting framework because the resulting outcome is in their interest or supports their viewpoint?
It may be of interest for students to consider some of the comments letter relating to the 2015 Exposure Draft on the Proposed Framework. The responses from comment letters have been summarised (in various feedback summary documents that can be accessed from the Consultation Feedback tab on the Project page at http://www.ifrs.org/projects/work-plan/conceptual-framework/#consultation).

2.22 The following information is provided for two items of property for a company. Property A was purchased five years ago for $400 000. It was intended to be used to build another factory but the company has now reorganised its original factory and it is no longer required. The company now intends to sell it. The current property market has dropped but is expected to rise when interest rates fall. If sold now the property is expected to realise $360 000.

Real estate experts have predicted that if the company waits for the property market to recover, it could realise $450 000.

Property B is the current factory. It was purchased ten years ago for $200 000. If sold now, it would be expected to realise $380 000 (and $500 000 if the property market recovers). The company has various estimates about its contribution to the profit of the company. Using current interest rates and various assumptions about future sales and costs, the property is calculated to have a present value (in terms of future cash flows) of $900 000. It is insured for $600 000 because this is the cost required to rebuild it.

The company has always recorded property using the historic cost basis.Other companies in the same industry have traditionally used the same basis, although about 40 per cent now use the fair value basis.
(a) For each of the properties, identify which cost or value would best meet each of the following qualitative characteristics (consider each separately):
- **Faithful representation**
- **Relevance**
- **Verifiability**
- **Comparability**
- **Understandability**

(b) Which of these costs or values do you think would be prudent?

(c) For each of the properties, choose which cost or value you consider should be stated in the financial statements. Explain why you have chosen it and how you balanced the qualitative characteristics.
(d) Do you think everyone would agree with your choices?
(LO4)

(a) *Faithful representation:*

Recall that faithful representation requires representation to faithfully present what it purports to represent and to be complete, neutral and free from error. This also requires a description of what the number represents. Hence:

- Cost, if clearly indicated as cost, for both is clearly a faithful representation(although remember we normally adjust cost via depreciation which involves estimates).
- Current and future fair values would also be a faithful representation providing that it is clear is an estimate and 'the nature and limitations of the estimating process are explained' (refer QC15).
- Likewise present values could also be considered a faithful representation providing that it is clear is an estimate and 'the nature and limitations of the estimating process are explained' in such a case it would also be required thatassumptionsetc. made to achieve this estimate were outlined.

Relevance:

Recall that relevance will vary depending on the user's perspective and the decision being made. For Property A the most relevant measure would be fair value as this is intended to be sold. Whether current fair value or expected fair value is more relevant will depend on users' perspective and also whether or not the company is intending to 'wait' until market recovers before selling.

For Property B from shareholders perspective (as interested in long term cash flows) then the present value would appear most relevant, although cost obviously also relevant (as this will determine profit made that can be distributed as dividends et). For other users, **perhaps a**ssessing liquidity or safeguarding funds provided to the company current fair value may be most relevant.

Verifiability:

The original costs could be verified from documentation.

The verifiability of current fair value would be more problematic and would depend on whether information was available about recent similar sales etc. Recall that to be verifiable one aspect is that independent observers could reach consensus. Future fair values would be even less verifiable, as this relies on making assumptions about the property market in the future, which would be more likely to vary and be contestable.

The verifiability of present value for Property B would also be less as this requires estimates of future events and is also influenced by choices about interest rates used. The insurance amount would generally be verifiable given it is part of a contract (this would vary, very reliable if set amount in policy; could vary if policy relates more generally to replacement costs).

Comparability:

As the companies have in the past used cost this would assist in comparison across time. As other companies use either cost or fair value these measures would be useful for comparisons.

Understandability:

The original costs, fair values and insurance value would be easily understood. The only value that could be more difficult to understand would be the present value for Property B as this requires an understanding of the item value of money and the impact of assumptions in relation to future cash flows, costs and interest rates. However the conceptual framework expects users to 'have a reasonable knowledge of business' (QC32).

(b) Assuming that we are considering prudence as defined in the *Proposed Framework* as 'the exercise of caution when making judgements under conditions of uncertainty' (2.18); i.e. not asymmetrical prudence.

Further it should be remembered that Prudence assists with neutrality, and a neutral depiction/approach is required for a faithful representation. Hence the discussion above relating to faithful representation would apply. However given need to exercise caution (this is prudence) then where there is uncertainty (this would apply measurements based on expected selling prices and present value) need to take 'care'. This would not necessarily mean that any specific measurement bases are 'ruled' out – but would need to carefully assess for example, the assumptions made, level of uncertainty etc. Being 'cautious' (i.e. prudent) could probably suggest that use cost or current market value (see discussion re-verifiability above).

(c) Students may arrive at different decisions. It could be argued:

- For Property A choose current fair value. Although less verifiable than cost,providing information is provided about this as an estimate it would be representationally faithful and it is more relevant given that the company intends to sell and future fair value is not sufficiently verifiable.
- For Property B choose cost. This is verifiable (especially as compared to present value)and still comparable with most other companies in the industry. Fair value is not relevant as intending to use asset.

(d) No, particularly in relation to Property B;it could be argued that cost has no relevance.

2.23 Think of brands or trademarks that you use and that you think would be valuable.

(a) Find the annual reports for the companies that have these brands and see if the brands are recognised in the balance sheet as assets and how these are valued.

(b) Identify any differences between the recognition of such assets between companies. Can you think of reasons why these differences have occurred?

(c) Does the relative values of tangible assets as compared to intangible assets reflect the relative importance of assets to the companies?

(d) Go to a brand valuing site (such as Interbrand or BrandZ) and compare the value of the brands to those reported in the financial statements. Given this comparison, do you think the balance sheets that you have examined provide useful information to users?

(LO7 and LO8)

Students will search a range of companies and brands some examples are below.

(a) Examples of brands recognised in annual reports are:

LVMH group (this owns a range of luxury brand names such as Louis Vuitton, Bvlgari, TAG Heuer, Sephora, Veuve Clicquot, Krug, Fendi) included brands at over 13 billion Euros in its 2016 balance sheet. The brands included are brands that LVMH group acquired/purchased. At total assets were 59 Billion Euros, brands recognised were around 20% of the total assets.

The Microsoft 2016 balance sheet includes $3 billion intangibles and half of these are market related (so would include brand names). As total assets were $193 billion brands recognised were around 1.5 % of the total assets and intangibles 3%..

Apple's 2016 balance sheet included Acquired intangible assets of $3 billion but these do not include any brands (licences and patents only). The total assets were $321 billion. (Note: Over $230 billion of assets were marketable securities or cash).

Coca Colas 2016 balancesheet included $US6 billion in Trademarks. This represents less than 1% of total assets of $US87 billion. The amount of intangible assets (including goodwill) represents around 20% of total assets.

(b) The differences in amounts are due to the fact that only acquired intangibles such as trademarks and brands can be recognised in the balance sheet. This is evident in contrast between amounts recognised in LVMH group (where growth strategy is to acquire a range of brands) and amounts recognised in balance sheets of companies such as Apple, Microsoft and Coca Colas where brand created internally and not purchased/acquired.

(c) Comparison to total assets & tangible assets is in answers to (a) above. For all of these companies the brands are far more important than their tangible assets.

(d) The table below includes 'valuations' of brands from 2 websites for brands associated with the companies discussed above. Note: These valuations are the value of the brand (not the company overall).

	Interbrand +	BrandZ*	
	In million $		
Louis Vuitton	22,919	29,242	
Microsoft	79,999	143,222	
Apple	184, 154	234,671	
Coca Cola	69,733	78,142	

+ http://interbrand.com/best-brands/best-global-brands/2017/ranking/
*http://brandz.com/charting/29

Prima facie, the balance sheets are omitting useful information by not included internally created brands. However, may wish to consider:

- how these would be measured.
- if narrative disclosures, re such brands, would be sufficient given the difficulty in measuring (there are some significant discrepancies between the 'values' in the table above).

Application of definitions and recognition criteria in the *Conceptual Framework*

The following questions (2.24–2.30) require you to apply the definitions and recognition criteria in the Conceptual Frameworkor Proposed Framework to specific cases. After you have answered these questions, compare your answers with those of other students. Do your answers differ? How did using the Conceptual Frameworkor Proposed Framework help you to make your decision?

2.24 A company has a copper mine in South Africa. It purchased the mining rights ten years ago for $20 million and has been operating the mine for the past ten years. It is estimated that there are about 8 million tons of copper in the mine.Because of a fall in world copper prices, the company has closed the mine indefinitely. At current world copper prices, the mine is uneconomic because the costs involved in extracting the copper are greater than the selling price.As the mine is in a remote and unpopulated areas there is no alternate use and it would not be able to be sold. If copper prices rise by more than 25 per cent, the company has stated that the mine would be reopened. In the foreseeable future (next 10 years or so) it is estimated there is a 20% probability that copper prices will rise sufficiently for extraction to be profitable.

Explain whether this mine would meet the definition and recognition criteria of an asset, applying the principles in:
- **the *Conceptual Framework***
- **the *Proposed Framework*.**

(LO3 and LO4)

Applying the *Conceptual Framework*:

Meeting the definition of an asset:

You would need to determine if the item has the 3 characteristics of an asset. Recall as asset is defined in the Conceptual Framework (para. 4.4) as:

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

Are there future economic benefits?

- The company has no current economic benefits flowing as at present, given current prices, the costs to extract are greater than the selling price of the copper extracted (but asset require future economic benefits not present economic benefits). It could be argued, however, that there are potential future economic benefits and thus, it meets the definition of an asset (whether these will be realised relates to the probability of copper prices increasing by 25%).
- Others could argue that future economic benefits are expected only IF copper prices rise by 25% and, hence, does not at present meet this characteristic.

Does the entity have control?

- Assuming that have taken position that have potential future economic benefits then company has control as is the only entity to have access to any potential benefits from

the mine (given legal rights it only can extract copper and sell) and so can restrict access to any benefits that could be realised (no one else can mine).

As a result of past event?

- Assuming that have taken position that have potential future economic benefits then control of these benefits due to past event of purchasing mining rights.

Meeting the recognition criteria:

Recall the recognition criteria are in the *ConceptualFramework* (para. 4.38):

(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.

Is it probable that future benefits will eventuate?

- This is dependent on whether copper prices rise by 25% or more. Would need to make a determination of this given expectations of the copper market/cycles/trends etc. If less than 50% probability would be expected to rise by 25% or more then would fail this and not be able to be recognised.

Is there a cost or value that can be measured reliably?

- It states that the company has purchased mining rights so presumably the cost of this is known and could be determined — reliable measure available. The *Conceptual Framework* does not require a reliable measure of value — it states cost or other value.

Students should recognise that there is no 'correct' answer. Whether or not an asset is recognised in such a situation depends on interpretations of the *Conceptual Framework* and application to the particular case plus the actual circumstances of the entity.

Applying the *Proposed Framework:*

Meeting the definition of an asset: recall that in the Proposed Framework:

- An asset is a present economic resource controlled by the entity as a result ofpast events (para 4.5). Further an economic resource is defined in para 4.6 as 'a right that has the potential to produce economic benefits'.

You would need to determine if the item has the 3 characteristics of an asset.
Is there a present economic resource?

- Although the company has no current economic benefits flowing as at present, given current prices, the costs to extract are greater than the selling price of the copper extracted but this is the potential to produce economic benefits and thus, it meets the definition of an asset. Note the definition of economic resource requires potential to produce benefits (not whether expected). As the *Proposed Framework* states: (whether these will be realised relates to the probability of copper prices increasing by 25%).

  4.13 For the economic resource to have the potential to produce economic benefits, it need not be certain, or even probable, that the resource will produce economic benefits. It is only necessary that the economic resource already exists and that there is at least one circumstance in which it would produce economic benefits.

- Further it states:
  5.17 An asset or a liability can exist even if there is a low probability that there will be an inflow or outflow of economic benefits (see paragraphs 4.13 and 4.27).

Does the entity have control?

- The company has control as is the only entity to have access to any potential benefits from the mine (given legal rights it only can extract copper and sell) and so can restrict access to any benefits that could be realised (no one else can mine).

As a result of past event?

- Then control of these benefits due to past event of purchasing mining rights.

In the *Proposed Framework* recognition is specified in para 5.9. An item meeting the definition is recognised if such recognition provides users of financial statements with:

(a) Relevant information about the asset or the liability and about any income, expenses or changes in equity.

- Need to consider whether including this item as an asset would provide relevant information. The Proposed Framework discusses the impact on relevance if there is only a low probability that an inflow or outflow of economic benefits will result (5.13) (so if low probability it may not be relevant). This will be a matter of judgement, whether consider recognition of an asset may be relevant (refer para 5.18 says may be relevant especially if measurement 'reflects the low probability and is accompanied by explanatory disclosures'.

(b) A faithful representation of the asset or the liability and of any income, expenses or changes in equity (extracts from para 5.9).

- It states that the company has purchased mining rights so presumably the cost of this is known and could be determined — so this measure available. However as noted above given probability it may be appropriate to adjust this if say expected values (given probability of prices increasing and receiving economic benefits) was lower than cost. So would be able to have a faithful representation. However could argue that the degree of measurement uncertainty too wide 'resulting information having little relevance (relating back to first recognition criteria),even if the estimate is properly described and disclosed' (5.21).

Students should recognise that there is no 'correct' answer. Whether or not an asset is recognised in such a situation depends on interpretations of the *Proposed Framework* and application to the particular case plus the actual circumstances of the entity.

2.25 The company is currently growing and it is expected that in five years an additional factory will need to be built to meet product demand at a cost of $500 000. The directors wish to recognise an expense of $100 000 and a liability (provision for future expansion) for each of the next five years.

Applying the principles in the *Conceptual Framework* or *Proposed Framework*, explain whether:

- **the definition of an expense is met.**
- **the recognition criteria for an expense are met**.

(LO3 and LO4)

Applying the *Conceptual Framework*:

Recall that the definition of an expense is related to assets and liabilities:

4.4(b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

4.25(b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

If we were to account for this as suggested by the directors, we would prepare the following journal entry:

Dr Expense
Cr Liability for Future Factory

It is probably easier to explain this in terms of the fact that there is no liability in this case. This would not constitute a liability. Recall that a liability hasthree characteristics:

1. Expected outflow of economic benefits.
2. A present obligation.
3. Due to past event.

Although it is probable a future outflow of resources will be made (i.e. money will be spent on replacement) there is currently no obligation to an external party to make this outflow in the future, so not as yet any past transaction.

As the *Conceptual Framework* states:

> 4.1.6 A distinction needs to be drawn between a present obligation and a future commitment.A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation.An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset.

IAS 37/AASB 137*Provisions, Contingent Liabilities and Contingent Assets*confirms this position and states that ‘only those obligations arising from past events and existing independently of the entity’s future actions (that is, the future conduct of its business’satisfy

the definition of a liability'because the entity can avoid the future expenditures by its future actions' (para. 19).

As we have no incurrence of liabilities or decreases in assets there is no expense.

Applying the *Proposed Framework*:

Again the definition of an expense is related to assets and liabilities:

- Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims(4.4).
  4.24 A liability is a present obligation of the entity to transfer an economic resourceas a result of past events.
- An asset is a present economic resource controlled by the entity as a result ofpast events (para 4.5). Further an economic resource is defined in para 4.6 as 'a right that has the potential to produce economic benefits'.

Again there is no liability in this case, and no expense, for the same reasons as explained above. There is no past event and no present obligation to any external party. As the *Proposed Framework* states:

> 4.39 An entity does not have a present obligation for the costs that will arise if it will receive benefits, or conduct activities, in the future (for example, the costs of future operations); the extent of the future transfer will not be determined by reference to benefits that the entity has received, or activities that it has conducted, in the past.

2.26 The company has recently issued some preference shares. The terms of theseshares are:

- **A fixed dividend of 3 per cent is payable each year. If no profit is availableto pay dividends in one year, these will be back-paid in future years.**
- **The preference shares will be redeemed (bought back) by the company inthree years at their issue price.**

Applying the principles in the *Conceptual Framework*or *Proposed Framework*, explain whether these preferenceshares should be considered as equity or a liability.
(LO3 and LO4)

Applying the *Conceptual Framework*:

First we need to consider the definitions of these items. In the *Conceptual Framework* these are:

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

(b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

(c) Equity is the residual interest in the assets of the entity after deducting all its liabilities.

The first point to note is that we consider the substance of the transaction not the legal form. So the fact that these are called 'shares' does not determine whether or not they are considered equity or liabilities.

The definition of equity is a residual — we measure this by considering assets and liabilities — so we must first consider the liability definition.

Recall that a liability has three characteristics:

1. Expected outflow of economic benefits.
2. A present obligation.
3. Due to past event.

Applying these to the first component of these shares — the cumulative fixed dividends.

Expected outflow of economic benefits:

- Yes — if and when these dividends are paid will require an outflow of cash by the company

A present obligation:

- Technically there is no legal right to dividends unless declared (which is normally at the discretion of directors). Hence, until a dividend was declared there would be no present obligation of the entity to make these future outflowsand this characteristic would not be met.

Due to past event:

- There is no event (until dividends declared which would then be past event) to obligate the company.

Therefore, this would suggest the share is equity.

Applying these to the second component of these shares — the redemption by the company in 3 years at the issue price.

Expected outflow of economic benefits:

- Yes — when these shares are bought back this will require an outflow of cash by the company

A present obligation:

- The terms of the issue indicate that the company is legally obligated to purchase the shares from the shareholders in 3 years' time for the issue price;therefore, this characteristic would be met.

Due to past event:

- There would be the issue of the shares under terms requiring company to redeem in 3 years' time.

Therefore, this would suggest the share is a liability.

In practice the accounting standards require separate classification of components into equity and liability respectively.

Applying the *Proposed Framework*:

First we need to consider the definitions of these items. In the *Proposed Framework* these are:

> 4.24 A liability is a present obligation of the entity to transfer an economic resource as a result of past events.
> 4.43 Equity is the residual interest in the assets of the entity after deducting all its liabilities.

The definition of equity as a residual is identical to that in the *Conceptual Framework*.

Recall that a liability has three characteristics:

1. Involves a transfer of an economic resource. Recall an economic resource is defined in para 4.6 as ' a right that has the potential to produce economic benefits'.
2. A present obligation.
3. Due to past event.

Although there is a difference in the definition (as does not mention expected transfer) the essential elements are the same. Therefore the analysis in relation to the definition applies here also, and the same conclusions would be drawn, in relation to both the dividend and the 'shares'.

2.27 A public museum has an exhibition of 20 rare fossils. A number of these were purchased at a total cost of $750 000, while six items were donated to the museum. If sold (to other museums and collectors) it is estimated that the fossils would sell for around $1.5 million, although the donated items (which would sell for $600 000) were donated on the condition that they would not be sold and are to be returned to the donors if no longer required by the museum. The museum charges a nominal fee of $2 for entry to the exhibit and receives on average $30 000 per annum in fees. It is estimated that it costs around $70 000 per annum to maintain the exhibition.

Applying the definition and recognition criteria for assets, explain whether the fossils could be recognised as assets of the museum.
(LO3 and LO4)

As discussed in the answer to question 2.18 such as item would not meet the definition of an asset in the IASB's*Conceptual Framework* as this is aimed at for profit entities and the discussion concerning what comprise 'economic benefits' reflects this by stating that 'The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity' (4.8). It could not be argued (given the negative cash flows from holding and using this asset) that it would meet the definition.

However it was noted that the AASB has made inclusions in the *Conceptual Framework (*and in accounting standards) so that these can apply for not –for-profit entities. For example:

> Aus54.1 In respect of not-for-profit entities, whether in the public or private sector, the future economic benefits are also used to provide goods and services in accordance with the entities' objectives. However, since the entities do not have the generation of profit as a principal objective, the provision of goods and services may not result in net cash inflows to the entities as the recipients of the goods and services may not transfer cash or other benefits to the entities in exchange.

AASB 116 Property Plant & Equipment includes the following:

> 15 An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.
>
> > Aus15.1 Notwithstanding paragraph 15, in respect of not-for-profit entities, where an asset is acquired at no cost, or for a nominal cost, the cost is its fair value as at the date of acquisition.

If the AASB's *Conceptual Framework* was applied then would argue would meet the definition of an asset as:

- The fossils do provided economic benefits in the form of providing the services that are the objectives of the museum. This would be the service as the role of a museum is to collect objects and materials of cultural, religious and historical importance, and maintain and display them to the public. As the AASB's *Conceptual Framework* states:
  > Aus54.2 In respect of not-for-profit entities, the fact that they do not charge, or do not charge fully, their beneficiaries or customers for the goods and services they provide does not deprive those outputs of utility or value; nor does it

preclude the entities from benefiting from the assets used to provide the goods and services. For example, assets such as monuments, museums, cathedrals and historical treasures provide needed or desired services to beneficiaries, typically at little or no direct cost to the beneficiaries. These assets benefit the entities by enabling them to meet their objectives of providing needed services to beneficiaries.

- It would be argued that although the museum does not have 'full' rights (e.g. cannot sell these items) that it has control in the sense can determine use of these fossils to meet their objectives.
- The past event would be the donation of the fossils to the museum.

Next we need to consider if recognition certain met.

- An item that meets the definition of an element should be recognised if:
  (a) it is probable that any future economic benefit associated with the item will flow to or from the entity.
    - This is established by the fact that can display these (and obviously public are viewing this as indicated by cash receipts from exhibiting these fossils).

  (b) the item has a cost or value that can be measured with reliability.
    - This may be more problematic. However the fact that these some of these have no cost (as noted) does not precluderecognition. For those purchased, these could be measured reliability at cost or fair value (as indicated in question– would need to consider reliability of this). For those donated then at fair value (but again would need to consider reliability of this). May also wish to consider how relevant fair value is if the donated assets cannot be sold.

2.28 Company A is suing Company B for $500 000 in relation to a breach of copyright. Company B produced designer clothes identical to those for which Company A holds legal rights, without permission and without paying Company A for permission to use the designs. Legal experts have advised Company A that it has a strong case and that there is a 60% likelihood that Company B will be required to pay damages, although these are estimated at $400 000.

(a) Explain whether the potential damages payable to Company A would meet the definition and recognition criteria of an asset, applying the principles in:

- **the *Conceptual Framework***
- **the *Proposed Framework*.**

(b) Explain whether the potential damages by Company B would meet the definition and recognition criteria of a liability, applying the principles in:

- **the *Conceptual Framework***
- **the *Proposed Framework*.**

(c) Would your answers to part (a) or (b) change if the likelihood of Company A winning the case was only 40%?

(d) Under current accounting standards IAS 37/AASB 137, an asset can only be recognised in such cases if it is virtually certain that income will be realised (paragraph 33) but a liability is recognised if probable. Do you think this difference in requirements is justified?

(LO3 and LO4)

(a) Applying the *Conceptual Framework*:

You would need to determine if the item has the 3 characteristics of an asset. Recall as asset is defined in the *ConceptualFramework* (para. 4.4) as:

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

Are there future economic benefits?

- The future economic benefits would be the damages (cash) expected to be received from company B.

Does the entity have control?

- Control (essentially the right to the damages) would be due to legal rights (as Company A) holds the rights to these designs. The fact that needs to go to court to enforce these rights would not impact on control.

As a result of past event?

- Past event that resulted in expected future economic benefits (in form of damages/cash) is the illegal use (breach by Company B)and thus action taken by Company A to seek damages.

Meeting the recognition criteria:

Recall the recognition criteria are in the *ConceptualFramework* (para. 4.38):

(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.

Is it probable that future benefits will eventuate?

- This is dependent on whether court decision is in favour of Company A and that not less than 50%. Legal advice has indicated strong case and 60% likelihood that will receive damages. So this recognition criteria is met.

Is there a cost or value that can be measured reliably?

- It states that the damages expected to be payable are $400,000. Could use this as the most likely measure, or could use an expected value measure — but would expect a reliable measure to be available.

Note: the standard AASB 137 currently prohibits the recognition of such 'contingent assets' even if meet the definition and recognition criteria in the *Conceptual Framework* on the basis that:

> 33 Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

Applying the *Proposed Framework*:

Meeting the definition of an asset: recall that in the Proposed Framework:

- An asset is a present economic resource controlled by the entity as a result ofpast events (para 4.5). Further an economic resource is defined in para 4.6 as 'a right that has the potential to produce economic benefits'.

You would need to determine if the item has the 3 characteristics of an asset.

Is there a present economic resource?

Again the future economic benefits would be the potential damages (cash) expected to be received from company B receivable via the enforcement of rights .

Note the definition of economic resource relates to 'rights' and states:

> 4.8 Rights that constitute economic resources may take the following forms:
> (a) Rights established by contract, legislation or similar means, such as:
> (iv) Rights to benefit from the obligations of another party to stand ready to transfer an economic resource if an uncertain future event occurs.
> (b) Rights arising from a constructive obligation of another party.

The economic resource is the right for Company A to receive damages from Company B.

Also it requires potential to produce benefits (not whether expected). As the *Proposed Framework* states:

> 4.13 For the economic resource to have the potential to produce economic benefits, it need not be certain, or even probable, that the resource will produce economic benefits. It is only necessary that the economic resource already exists and that there is at least one circumstance in which it would produce economic benefits.
>
> 5.17 An asset or a liability can exist even if there is a low probability that there will be an inflow or outflow of economic benefits (see paragraphs 4.13 and 4.27).

Does the entity have control?

- As above as these are enforcement rights has control. Control (essentially the right to the damages) would be due to legal rights (as Company A) holds the rights to these designs. The fact that needs to go to court to enforce these rights would not impact on control.

As a result of past event?

- Past event that resulted in expected future economic benefits (in form of damages/cash) is the illegal use (breach by Company B) and thus leading to enforceable right by Company A to seek damages.

In the *Proposed Framework* recognition is specified in para 5.9. An item meeting the definition is recognised if such recognition provides users of financial statements with:

(a) Relevant information about the asset or the liability and about any income, expenses or changes in equity.
  - Need to consider whether including this item as an asset would provide relevant information. The Proposed Framework discusses the impact on relevance if there

is only a low probability that an inflow or outflow of economic benefits will result (5.13)but probability in this case (60%) is not low.Further the *Proposed Framework* states:

- 2.13 An estimate can provide relevant information, even if the estimate is subject to a high level of measurement uncertainty.
- This will be a matter of judgement, whether consider recognition of an asset may be relevant (refer para 5.18 but especially given the nature (another company breaching the company's patent) would be expected to be relevant.

(b) A faithful representation of the asset or the liability and of any income, expenses or changes in equity (extracts from para 5.9).

- It states that the damages expected to be payable are $400,000. Could use this as the most likely measure, or could use an expected value measure — but would expect a faithful representation available. This would include disclosure of assumptions/estimations.

Given facts here it would be difficult to argue that the degree of measurement uncertainty too wide 'resulting information having little relevance (relating back to first recognition criteria), even if the estimate is properly described and disclosed' (5.21).

Students should recognise that there is no 'correct' answer. Whether or not an asset is recognised in such a situation depends on interpretations of the *Proposed Framework* and judgments and application to the particular case plus the actual circumstances of the entity.

(b) Applying the *Conceptual Framework:*

First we need to consider the definitions of a liability, which is:

- A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. (4.4)

Recall that a liability has three characteristics:

1. Expected outflow of economic benefits.
2. A present obligation.
3. Due to past event.

Would argue that would meet definition:

- Is future outflow of economic benefits/ resources (potential payment of damages)?
- Present obligation: yes, although there is not yet any court decision the company is presently obligated due to the fact that they have copied Company A's designs illegally. This is constructive obligation derived from the facts of this case.
- Past event: illegal copying and use of designs of Company A.

Meeting the recognition criteria:

Recall the recognition criteria are in the *ConceptualFramework* (para. 4.38):

(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.

Is it probable that future outflow will be required?

- This is dependent on whether court decision is in favour of Company A and that not less than 50%. Legal advice has indicated strong case and 60% likelihood that Company B will have to pay damages. So this recognition criteria has been met.

Is there a cost or value that can be measured reliably?

- It states that the damages expected to be payable are $400,000. Could use this as the most likely measure, or could use an expected value measure — but would expect a reliable measure to be available.

Applying the *Proposed Framework:*

First we need to consider the definition of a liability which is:

- 4.24 A liability is a present obligation of the entity to transfer an economic resourceas a result of past events.

Recall that a liability has three characteristics:

1.Involves a transfer of an economic resource. Recall an economic resource is defined in para 4.6 as ' a right that has the potential to produce economic benefits'.
   - This case does involve the transfer of resources (potential payment of damages to another company)

2. A present obligation. The *Proposed Framework*states:
   4.31 An entity has a present obligation to transfer an economic resource if both:
   (a) the entity has no practical ability to avoid the transfer; and

(b) the obligation has arisen from past events; in other words, the entity hasreceived the economic benefits, or conducted the activities, that establishthe extent of its obligation.

- 4.27 An entity's obligation to transfer an economic resource must have the potentialto require the entity to transfer an economic resource to another party. It neednot be certain, or even probable, that the entity will be required to transfer aneconomic resource, but the obligation must already exist and there must be atleast one circumstance in which it will require the entity to transfer aneconomic resource. One example of such an obligation is an obligation to standready to transfer an economic resource if an uncertain future event occurs.
- Hence would have a present obligation. Although there is not yet any court decision the company is presently obligated due to the fact that they have copied Company A's designs illegally and the Company cannot avoid the transfer.

3. Due to past event: illegal copying and use of designs of Company A.

In the *Proposed Framework* recognition is specified in para 5.9. An item meeting the definition is recognised if such recognition provides users of financial statements with:

(a) relevant information about the asset or the liability and about any income, expenses or changes in equity and

- Need to consider whether including this item as an asset would provide relevant information. The Proposed Framework discusses the impact on relevance if there is only a low probability that an inflow or outflow of economic benefits will result (5.13) but probability in this case (60%) is not low. Further the *Proposed Framework* states:

  2.13 An estimate can provide relevant information, even if the estimate is subject to a high level of measurement uncertainty.
- This will be a matter of judgement, whether consider recognition of a liability may be relevant (refer para 5.18) but especially given the nature (breaching another company patent and having to pay damaged) would be expected to be relevant.

(b) a faithful representation of the asset or the liability and of any income, expenses or changes in equity (extracts from para 5.9).

- It states that the damages expected to be payable are $400,000. Could use this as the most likely measure, or could use an expected value measure — but would expect a faithful representation available. This would include disclosure of assumptions/estimations.
- Given facts here it would be difficult to argue that the degree of measurement uncertainty too wide 'resulting information having little relevance (relating back to first recognition criteria), even if the estimate is properly described and disclosed' (5.21).

Students should recognise that there is no 'correct' answer. Whether or not a liability is recognised in such a situation depends on interpretations of the *Proposed Framework* and judgments and application to the particular case plus the actual circumstances of the entity.

(c) The differences would be:

Applying the *Conceptual Framework*:

As the recognition criteria only allows recognition is probable (usually interpreted as a likelihood of 50% or more) then no asset or liability could be recognised, as the recognition criteria would not be met.

Applying the *Proposed Framework*:

This change in probability is unlikely to impact on decision as to whether to recognise the items (whether the asset or liability) if applying the *Proposed Framework.*

There is no longer a 'specified' probability level that determines whether or not an item is recognised. The *Proposed Framework* explicitly states:

> 5.17 An asset or a liability can exist even if there is a low probability that there will be an inflow or outflow of economic benefits (see paragraphs 4.13 and 4.27).
>
> 5.18 Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or the liability may provide relevant information, especially if the measurement of the asset or the liability reflects the low probability and is accompanied by explanatory disclosures.

The *Proposed Framework* discusses the impact on relevance if there is only a low probability that an inflow or outflow of economic benefits will result (5.13) but probability in this case (40%) is not so low that would normally be considered to impact on potential relevance.

However the reduced probability may be reflected in the measurement (if expected value used) to reflect a faithful representation.As the *Proposed Framework* states:

> 2.13 An estimate can provide relevant information, even if the estimate is subject to a high level of measurement uncertainty.

This example demonstrates the differential impact of the recognition criteria. The inclusion of a probability threshold in *Conceptual Framework's* recognition criteria results in a 'bright line' between items being recognised or not. This is not the case in the *Proposed Framework*.

(d) There is no correct answer here.

This is clearly an example of the application of asymmetrical prudence, in the sense of deliberate bias so arguments both for and against such an approach could include:

- Could argue treating such items differently compromises presentation of neutral financial reports. As the understatement (or exclusion) or overstatement of particular items could increase 'risks' to users making decisions (e.g. if understated expected liabilities) then need to take more care when this could occur. However taking more care would not mean should be biased, as users need unbiased information to base their decisions on.
- Could argue that asymmetric prudence in sense of not allowing an asset to be recognised in these circumstances is a reasonable approach. Perhaps could argue there are a number of financial failures or distortions where 'non-conservative' accounting practices have been complicit (examples are discussed in chapter 1 re rebates). If conservative accounting practices were required – so if such bias applied, then perhaps these could have been mitigated. Could be argued that a neutral approach favours investors but asymmetric prudence more useful for creditors. Also this 'ban' on assets should minimise the opportunities to manage or manipulate accounting
- Standards can include restrictions that are not embodied in the frameworks to balance potential costs and benefits, especially where perceived risk of opportunistic accounting.
- Taking a deliberate conservative bias, so ensuring, even if risk of overstatement of assets or understatement of liabilities minimal/ negligible.
- By failing to include such items, the financial reports are often omitting what are the most important assets/items to a company. This therefore reduces the usefulness of the financial reports.
- Inclusion of such items may involve subjectively. Could this result comprising its usefulness or in difficultly auditing such information or provide directors or others with opportunities to bias results. This could impact overall on the usefulness of the financial reports.

2.29 A company in Europe recently purchased a gold mine on a small pacific island for $80 million. Shortly after beginning operations there was political unrest and the mine had to be abandoned as it was attacked by rioters. The political unrest has now developed into a civil war that is expected to be prolonged and continue for a number of years. While this is occurring the company will not be able to operate the mine. It is expected that once the civil war ends the company will be able to reopen the mine.

(a) Explain whether this mine would meet the definition and recognition criteria of an asset, applying the principles in:
- **the *Conceptual Framework***
- **the *Proposed Framework*.**

Assume further information is provided, as below.

Three years later the civil war is nearing an end and it is expected that elections will be held and a government will be established shortly after. However, one of the potential parties for government (this party has a 30% chance of being elected) has announced that all foreignowned businesses (including mines) will be seized by the government and no compensation will be paid. A key issue in the civil war was the ownership of resources by foreign countries. However, the party that is likely to be elected has ensured all foreign companies that their ownership rights will be formally recognised, and that most companies will be able to continue operations, or will receive compensation if property is seized.

(b) Explain whether this new information would change your answers in part (a). (LO3, LO4 and LO8)

(a) *Applying the Conceptual Framework:*

You would need to determine if the item has the 3 characteristics of an asset. Recall as asset is defined in the *ConceptualFramework* (para. 4.4) as:

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

Are there future economic benefits?

- The company has no current economic benefits flowing as at present, but this is not required. There is clearly a stock of gold in the mine and since there is stock of minerals that if mined could be sold there are future economic benefits embodied in the mine.

Does the entity have control?

The company clearly owns the mine (states that it was purchased recently) but the issue is whether, despite the past transaction giving ownership, the company presently has control.

The article states that mine is abandoned/closed, and that there are preconditions for reopening (end of civil war) which are outside of the control of the company. The company has no access to the mine at present and is unsure when, or whether, access will be possible in the future. This indicates present lack of control of the mine site and the benefits embodied in it.

Others may argue that since the company has ownership rights present lack of access to the mine merely relates to probability that future economic benefits will eventuate and does not reduce control. There are future economic benefits in the mine (gold) and if these can be accessed the company (as owner) will receive these and therefore has control.

As a result of past event?

- Assuming that have taken position that have control of potential future economic benefits then to past event of purchase of gold mine.
- If take view of no current control, past event will be when and if they regain access to mine.

Meeting the recognition criteria:

Recall the recognition criteria are in the *ConceptualFramework* (para. 4.38):

(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.

Probability:

A future event, the ending of civil war therefore resumption of access to the mine is necessary to establish any probability of future economic benefits. The article states that prolonged and over a number of years, but also states once ended expect to be able to resume mining. To meet this recognition criteria only need to establish that probable (more likely than not) that civil war will end and access be granted to reopen mine. However civil wars

have been known to go on indefinitely. So need to establish probability of these events occurring. Given limited information, facts indicate that it is likely that that mine will reopen although exact time cannot be established.

Is there a cost or value that can be measured reliably?

- It states that the company has purchased the mine so presumably the cost of this- $80 million - is known— reliable measure available. The *Conceptual Framework* does not require a reliable measure of value — it states cost or other value.

Students should recognise that there is no 'correct' answer. Whether or not an asset is recognised in such a situation depends on interpretations of the *Conceptual Framework* and application to the particular case plus the actual circumstances of the entity.

Applying the *Proposed Framework:*

Meeting the definition of an asset: recall that in the *Proposed Framework*:

- An asset is a present economic resource controlled by the entity as a result ofpast events (para 4.5). Further an economic resource is defined in para 4.6 as 'a right that has the potential to produce economic benefits'.

You would need to determine if the item has the 3 characteristics of an asset.

Is there a present economic resource?

Although the company has no current economic benefits flowing as at present, given that clearly a stock of gold in the mine and since there is stock of minerals that if mined could be sold there are potential economic benefits embodied in the mine, so is an economic resource.

As the *Proposed Framework* states: (whether these will be realised relates to the probability of the civil war ending and the company being able to open the mine).

> 4.13 For the economic resource to have the potential to produce economic benefits, it need not be certain, or even probable, that the resource will produce economic benefits. It is only necessary that the economic resource already exists and that there is at least one circumstance in which it would produce economic benefits.

Further it states:

> 5.17 An asset or a liability can exist even if there is a low probability that there will be an inflow or outflow of economic benefits (see paragraphs 4.13 and 4.27).

Does the entity have control?

- Again, the company clearly owns the mine (states it was purchased recently) but issue is whether, despite the past transaction giving ownership, the company presently has control.
- As discussed above, has no access to the mine at present and is unsure when, or whether, access will be possible in the future. This could indicate present lack of control of the mine site and the benefits embodied in it. However, since the company has ownership rights present lack of access to the mine merely relates to probability that future economic benefits will eventuate and does not reduce control. There are future economic benefits in the mine (gold) and if these can be accessed the company

(as owner) will receive these and therefore has control. Given the emphasis in the *Proposed Framework*that there is at least one circumstance in which it would produce economic benefits, would favour interpretation that has control.

As a result of past event?

- Then control of these benefits due to past event of purchasing mine.

In the *Proposed Framework* recognition is specified in para 5.9. An item meeting the definition is recognised if such recognition provides users of financial statements with:

(a) Relevant information about the asset or the liability and about any income, expenses or changes in equity.

- Need to consider whether including this item as an asset would provide relevant information. The article states that prolonged and over a number of years, but also states once ended expect to be able to resume mining. The Proposed Framework discusses the impact on relevance if there is only a low probability that an inflow or outflow of economic benefits will result (5.13) (so if low probability it may not be relevant). This will be a matter of judgement, and also consideration of the circumstances (i.e. assessment of likelihood will be able to resume mining would be one factor) whether consider recognition of an asset may be relevant. Even if very uncertain, refer para 5.18 says may be relevant especially if measurement 'reflects the low probability and is accompanied by explanatory disclosures'. Given the nature of the event (the purchase of a mine and its almost immediate closure), information about this would be relevant although this does not necessarily mean that would recognise an asset.

(b) a faithful representation of the asset or the liability and of any income, expenses or changes in equity (extracts from para 5.9).

- It states that the company has purchased mineand the cost of this is known - $80million -so this measure available. However may be appropriate to adjust this if say expected values (given probability of access to mine resuming receiving economic benefits) was lower than cost. So would be able to have a faithful representation. However could argue that the degree of measurement uncertainty too wide 'resulting information having little relevance (relating back to first recognition criteria), even if the estimate is properly described and disclosed' (5.21).

Students should recognise that there is no 'correct' answer. Whether or not an asset is recognised in such a situation depends on interpretations of the *Proposed Framework* and application to the particular case plus the actual circumstances of the entity.

Assume further information is provided, as below.

Three years later the civil war is nearing an end and it is expected that elections will be held and a government will be established shortly after. However, one of the potential parties for government (this party has a 30% chance of being elected) has announced that all foreign owned businesses (including mines) will be seized by the government and no compensation will be paid. A key issue in the civil war was the ownership of resources by foreign countries. However, the party that is likely to be elected has ensured all foreign companies that their ownership rights will be formally recognised, and that most companies will be able to continue operations, or will receive compensation if property is seized.

(b) The differences would be:

Applying the *Conceptual Framework*:

Essentially same analysis (as before) re asset definition.

As the recognition criteria requires recognition where is probable (usually interpreted as a likelihood of 50% or more) then as 70% likely that will either be able to resume operations, or receive compensation then is clear thatthis recognition criteria would be met.

Regarding reliable measurement, again this is a cost that could be measured reliably. However but could also consider measuring at compensation expected to be received if this could be measured reliability.

Applying the *Proposed Framework*:

This information may impact on decision (depending on previous assessment) as to whether to recognise an asset if applying the *Proposed Framework* as it is now clear that the probability is not low.

However the new information may be reflected in the measurement (if expected value used had been used then would change this) or alternatively could consider measuring at compensation expected to be received, if this more relevant (would depend on company's intentions). As the *Proposed Framework* states:

> 2.13 An estimate can provide relevant information, even if the estimate is subject to a high level of measurement uncertainty.

2.30 A company has an extensive customer base. Over many years, it has built a detailed customer list, which includes various data including demographics, contact details, purchasing history and preferences. It has spent quite a lot of resources on developing this customer list so that it can effectively target marking campaigns and manage customer relations. A number of businesses have approached the company to purchase their customer list and have offered prices from $60 000 to $210 000. However, the company has decided not to sell at this stage.

(a) Explain whether this customer list would meet the definition and recognition criteria of an asset, applying the principles in:

- **the *Conceptual Framework***
- **the *Proposed Framework*.**

(b) Requirements in accounting standards currently prohibit the recognition of internally generated intangibles such as customer lists and only allow cost basis to be used for any intangible assets recognised. Do you think these restrictions are justified?

(LO3 and LO4)

(a) Applying the *Conceptual Framework:*

Recall in the *Conceptual Framework* an asset is:

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

A customer list would normally meet definition as:

- Future economic benefits would be the ability to use the customer list to increase sales (by targeted marketing campaigns or managing customer relations which would build goodwill etc.) and there is also the potential to receive cash from selling the customer list.
- Control would be established as the entity has access to the customer list and can deny access to others. The *Conceptual Framework* states that:
    - Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definitionof an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when,by keeping that know-how secret, an entity controls the benefits that areexpected to flow from it.
- Past event –would be activities of the entity that created the customer list.

The *ConceptualFramework* states that:

4.38/83 An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

- Given information (especially fact that had offers from other companies) the probability would be met (i.e. it would be more likely rather than less likely that benefits would be received either through use and/or sale of this customer list)

(b) The item has a cost or value that can be measured with reliability.

- Recall that reliability essentially equates to representational faithfulness. Although the information states that have spent a lot of resource developing this, it would be difficult to determine or estimate resources specifically used to develop this customer list (as opposed to overall goodwill). Hence would likely be no cost that could be measured reliably. However could potentially estimate a fair value reliability given offers made. Without specific offers, it would be argued that extremely difficult to value a customer list (as value is in its uniqueness often). However customer lists are regularly traded and in some industries (such as insurance) there are bases for estimating these available.

Therefore it could be argued that this customer list would meet the definition of an asset and the recognition criteria in the *Conceptual Framework.*

Applying the *Proposed Framework*:

Recall in the *Proposed Framework* an asset is:

- An asset is a present economic resource controlled by the entity as a result ofpast events (para 4.5). Further an economic resource is defined in para 4.6 as ‘a right that has the potential to produce economic benefits’.

A customer list would normally meet definition as:

- It is an economic resource. The use of the customer list has potential to produce future economic benefits to increase sales (by targeted marketing campaigns or managing customer relations which would build goodwill etc.) and there is also the potential to receive cash from selling the customer list. Hence can result in benefits/cash flows and the entity would have right. Paragraph 4.8 states:

  4.8 Rights that constitute economic resources may take the following forms:

  (c) other rights that give the entity the potential to receive future economic benefits that are not available to all other parties, for example, rights to the economic benefits that may be produced by items such as know-how not in the public domain or by customer or supplier relationships. (see paragraph 4.20).
- Control would be established as the entity has right to use/access the customer list and can deny (or allow) access to others. The *Proposed Framework* states:

  4.19 An entity has the ability to direct the use of an economic resource if it has the right to deploy that economic resource in its activities, or to allow another party to deploy the economic resource in that other party's activities.

  4.20 Although control of an economic resource usually arises from legal rights, it can also arise if an entity has the present ability to prevent all other parties from directing the use of it and obtaining the benefits from the economic resource. For example, an entity may control know-how obtained from a development activity by having the present ability to keep that know-how secret.
- Past event: would be activities of the entity that created customer list.

Recognition criteria:

In the *Proposed Framework* recognition is specified in para 5.9. An item meeting the definition is recognised if such recognition provides users of financial statements with:

(a) Relevant information about the asset or the liability and about any income, expenses or changes in equity.

- Information about the customer list could be relevant to users.

(b) A faithful representation of the asset or the liability and of any income, expenses or changes in equity (extracts from para 5.9).

- Again, as above, measuring cost would be problematic. However likely that could provide a faithful representation in this case due to offers made. If could be argued however that as not intending to sell that such as measure is not relevant to users (or alternatively could argue represents a 'minimum value'; as company has opted not to sell, then presumably believes benefits in keeping this exclusively is more).

The *Proposed Framework* discusses uncertainties (such as existence uncertainty, low probability and measurement uncertainty) and explains that such uncertainties may impact on relevance (and therefore impact on whether recognition criteria are met). The issue for this asset would relate to measurement uncertainly. However it could be arguedthat if there has been an 'offer' (or a sales of similar customer lists etc.) then this would provide a means of faithful representation.

Therefore it could be argued that the customer list would meet the definition of an asset and the recognition criteria in the *Proposed Framework*.

(b) There is no correct answer here. Arguments for/against banning internally generated intangibles include:

- By failing to include such items, the financial reports are often omitting what are often the most important assets/items to a company. This therefore reduces the usefulness of the financial reports.
- The incorporeal nature of some items such as (for items such as human capital, innovations) necessarily means that in many instances identifying these and deciding on what impact or significance they have or may have is inherently subjective. This could impact on the usefulness of any information provided.
- How would we measure some intangibles that are internally generated? These would be difficult to value (either in attributing costs or future economic benefits).
- Inclusion of such items may involve subjectively. Could this result comprising its usefulness or in difficultly auditing such information or provide directors or others with opportunities to bias results. This could impact overall on the usefulness of the financial reports.

It should be noted that IAS 38/AASB 138, para 128 *encourages* entities to provide a description of significant intangible assets that have not been recognised as assets due to failing the recognition criteria.

In relation to restriction to cost basis for acquired intangibles arguments for/against would include:

- This is inconsistent with measurement of other acquire assets (such as property) which can be measured after acquisition at fair value.
- For some purchased intangibles, such as acquired goodwill, it would be very difficult to estimate increases in such values and therefore there would be 'too much' subjectively (measurement uncertainty) which could impact on usefulness and also provide opportunity to manipulation of financial information (or bias).

Case study questions

Case study 2.1

Code of ethics

Questions

1. **Can you identify any potential problems or criticisms of the principles outlined in the *Conceptual Framework* in the case?**
2. **Do you think using these principles would be interpreted and applied consistency between the accountants in determining whether an action is ethical?**
3. **How effective do you think such a framework is in (a) ensuring accountants act ethically and (b) enforcing or penalising unethical behaviour?**
4. **Would a set of specific rules about what constitutes ethical and unethical behaviours in specific circumstances be more or less useful than the principles in the code of conduct outlined?**

(LO3)

1. The key problem with this set of principles is their broadness and the vagueness which is associated with conceptual frameworks in general. The advantages of this conceptual framework are identified at the end of the extract. The key disadvantage is in the vagueness of terms and in specific application of these principles to practice. For example, what level of professional knowledge is to be maintained to ensure competent service?

2. Students should recognise that there would be differences in interpretation and application of these concepts. For example, what would people interpret as honest? Would the idea of this vary between individuals and particular circumstances?(In terms not of lies, but missions or incomplete statements). Is honesty in business simply ensuring the letter of law is followed or is it more than this?

3. Students should recognise that whether or not people, such as accountants, act ethically is influenced by a number of factors that interact. These would include:

- The moral code/conscience of the individual accountant.
- Expectations of the profession (such as set out in such a code).
- Expectations of peers — this could include the culture of the company/context.
- Risks of unethical behaviour being detected — would need to consider levels of enforcement of behaviour here.
- Consequences of being found to have acted unethically (e.g. would it mean going to prison).
- Consequences of the unethical behaviour to the individual (i.e. the rewards/expected outcome — is it worth lots of $s) and to others (if seen as not hurting anyone specifically, often people are more willing to distort the truth).
- Consequences of not acting ethically (e.g. if being pressured by management to distort accounts would you lose your job/promotion if you do not act unethically).
- Personal circumstances.

While a *Framework* can provide guidelines and can be used by individuals to defend ethical behaviour, in reality a number of factors combine. A key factor is the character of the individual; there will always be individuals who do the right thing regardless of consequences to themselves, and others who will readily ‘do wrong’ for their own benefits.

Re-enforcing or penalising in cases where there is debate about the whether a particular action is or is not unethical, it is likely that, as a broad set of principles, it is open to interpretation that this would make enforcement in these 'borderline' cases more difficult.

4. A broad set of principles can mean differentinterpretations (so less consistency) and can lead to people interpreting events as outside the restrictions placed by the principles.

The advantages of specific rules (rather than principles) are that it is clearer whether an action is or is not ethical. Therefore, less ambiguity, more consistency and it would be easier to enforce and penalise. However, requirements into narrowing rules means that as long as the rule meet actions outside of the specific rules are not 'unethical' as the rules specify ethical and unethical behaviours. Also, in practice you cannot specify rules for every possible scenario/situation. An analogy is the advantages and disadvantages of principles based accounting standards versus rules based as discussed in chapter 3.

While there may be ambiguities in a broad set of principles, it is often argued that principles require a higher level consideration of overall ethics (so place a higher burden of responsibility on the individual in making the judgement as to whether something is or is not ethical). To justify behaviour, if specific rules are set, the individual only needs to argue that they have followed the rules; not that their action is ethical in accordance with a set of higher order principles.

Case study 2.2

Is prudence still a virtue?

Questions

1. **The article claims that although accountants need to use prudence, the concept need no longer be included as the standards and frameworks are now more developed. Do you agree with this?**
2. **The UK Financial Reporting Council has argued that the essence of prudence is 'asymmetric' prudence; a lower threshold for the recognition of liabilities and losses than for assets and gains and so the definition of prudence in the *Proposed Framework* is incorrect. How would you interpret prudence? Do you agree that it should include 'asymmetric' prudence.**
3. **The IASB acknowledged that asymmetric prudence is (and will likely be) incorporated into some accounting standards but that asymmetric prudence is not a necessary characteristics of information so should not be included in the *Conceptual Framework* and that its use should be on an exception basis. Others have argued that this guidance about when it is appropriate to use asymmetric prudence should be included in the *Conceptual Framework*.**
   (a) Can you think of situations where asymmetric prudence would be justified?
   (b) If the IASB expect to use asymmetric prudence in some accounting standards do you believe that guidance should be provided in the *Conceptual Framework*?
   (LO4)

1. *For background:* **t**he definition of prudence in the *Proposed Framework* is 'the exercise of caution when making judgements under conditions of uncertainty'(2.18). This is interpreted as 'cautious prudence — being equally cautious when making judgements about any items, 'without needing to be more cautious in judgements relating to gains and assets than those relating to losses and liabilities' rather than asymmetric prudence. The IASB argues that this is consistent with neutrality; 'A neutral depiction is without bias in the selection or presentation of financial information (2.17).'

It will be a personal position as to whether or not students agree with re-including prudence. Some arguments for/against would be:

- Unnecessary to include as professional judgment would require care/caution to be applied where there is uncertainty even if prudence was not explicitly included in the framework. The article essentially argues that as prudence is implicit in the exercise of 'good judgment' anyway.
- The article argues that as accounting concepts (such as qualitative characteristics) now more developed, no need for explicit inclusion of prudence.
- Inclusion causes more confusion as there can be different interpretations, especially if guidance lacking.
- Is useful to include as emphasises need (and therefore an obligation/duty) to especially take care in conditions of uncertainty.
- Could argue that unnecessary for application, however as many constituents argued for its reintroduction, a compromise made to assist in acceptance of changes to the framework (so political reason).

2. The IASB defines asymmetric prudence as — being *more* cautious about certain items than others; 'a need for systematic asymmetry: losses are recognised at an earlier stage than gains are'. It distinguishes this from deliberate under- or overstatement of items to influence whether information is received favourably or unfavourably.

How students interpret prudence could vary from:

(a) Taking particular care when there is uncertainty, for all items regardless of the nature of the item (i.e. whether gain or loss).
(b) Taking more care, when there is uncertainly, for particular items (where the overstatement or understatement of these could increase 'risk' to users) but still ensuring not biased (i.e. towards being optimistic or pessimistic).
(c) Taking a deliberate conservative bias, so ensuring, even if risk of overstatement of assets or understatement of liabilities minimal/ negligible.

Both (b) and (c) above have been referred to as asymmetrical prudence, although IASB defines as (b).

Again whether students agree with asymmetric prudence could vary:

- Could argue against any asymmetric prudence on the basis, as the article states, that this compromises presentation of neutral financial reports.
- Could argue that asymmetric prudence in sense of (b) above is a reasonable approach. As the understatement or overstatement of particular items could increase 'risks' to users making decisions (e.g. if understated expected liabilities) then need to take more care when this could occur. However taking more care would not mean should be biased, as users need unbiased information to base their decisions on. Also applying this unbiased approach, should minimise the opportunities to manage or manipulate (e.g. as article states to use 'cookie jar' accounting).
- Could argue that asymmetric prudence in sense of (c) above is a reasonable approach. Perhaps could argue there are a number of financial failures or distortions where 'non-conservative' accounting practices have been complicit (examples are discussed in chapter 1 re rebates). If conservative accounting practices were required – so asymmetrical prudence in the sense of (c) applied, then perhaps these could have been mitigated. Could be argued that a neutral approach favours investors but asymmetric prudence more useful for creditors.

3. (a) Students may identify a range of situations but would expect where standards to include asymmetric prudence where higher degree of uncertainty and therefore higher probability that there is a significant risk of resulting in a material adjustment in the future, and/or where more potential ability to bias/manipulate results.

Examples in existing standards included:

- Ban on recognition of internally generated intangibles.
- Requirements to expense all research expenditures.
- Requirement in the new Revenue standard, AASB 15 *Revenue from Contracts with Customers* that variable consideration can only be included/recognised when it is highly probable that a significant reversal in the amount of cumulative revenue recognised will not occur.

3. (b) Again, views could vary:

- Could be argued if included in standards on an 'exception' basis (so basic principle is that statement neutral) then no need to include guidance in the framework. It would be more appropriate to include the guidance in the context of the particular standard. It should be understood that it is expected at times (due for example to cost constraint that also considers economic consequences in relation to the particular events/transactions) that standards will not be consistent with the conceptual framework.
- As framework is the basis for accounting standards, then guidance should be provided; the guidance could be about when it is appropriate to consider/use asymmetric prudence and /or what is meant by the term (so assisting in interpretation).