Recognition and measurement of the elements of the financial statemets

Primacy of definitions

- It must be established
- Based on either:
- assets and liabilities;

or:

expenses and income.

Primacy of decisions

- to start with on assets, there is a hierarchy of decisions:
- Is the item an asset?
- If yes, should the asset be recognized in the balance sheet?
- If yes, how should it be measured?

Primacy of decisions

- which definitions have primacy
- is examined first in the context of assets and expenses
- In the case of payments related to assets,
- decisions about:
 - whether such payments should be added to the asset
 - or should be treated as an expense

Examples of such payments

- repairs;
- decorating or redecorating;
- extensions;
- improvements;
- replacements of parts
- future inevitable payments for dismantling

'applications' of resources

- They are all recorded as 'debits' in the double-entry system.
- Those costs that do not generate assets (and are not added to existing assets)
- are expenses

 accounting can work on one of two bases:

Method 1

 Expenses of 20X7 are the costs of any period that relate to 20X7;

And therefore . . .

• **Assets** at the end of 20X7 are any remaining costs.

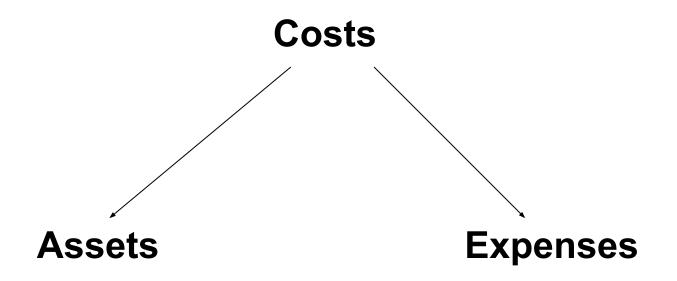
Method 2

- Assets at the end of 20X7
 - are resources controlled by the entity
 - that are expected to give benefits;

and therefore . .

Expenses are any remaining costs.

Assets and expenses



Definition of the asset

- The Framework gives primacy to the second way of defining the elements,
- an asset defined as follows (par. 49):
- a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise

The Framework

- This has the effect of reducing the importance of the 'matching' concept,
- If an expense is postponed in order to match it against a future revenue,
- it would have to be stored in the balance sheet as an asset.
- this is not allowed unless the amount meets the definition of an asset

Liability

Framework, paragraph 49:

A liability is a present **obligation** of the enterprise arising from **past events**, the settlement of which is expected to result in an **outflow** from the enterprise of resources

Obligation

- Obligation is an unavoidable requirement to transfer resources to a third party
- Many liabilities are clear legal obligations of exact amounts,
 - such as accounts payable or loans from the bank.

Provisions

- Some liabilities are of uncertain timing or amount
- These are called 'provisions'
- Depending on the nature of legal contracts, some of these provisions are also legally enforceable,
 - such as provisions to pay **pensions** to retired employees or
 - to repair machinery sold to customers that breaks down soon after sale

Provisions

 Some obligations are not based on precise laws or legal contracts

 but would probably be enforced by a court of law based on normal business practices

Other provisions

- outside of IFRS requirements,
- some companies might make provisions when there is no obligation.

- the example of provisions for repair expenses.
- The double entry for the creation of the liability is an expense.

repair provision – example

 The double entry for a repair provision would be as follows, at the end of 20X7

Dr Repair expense of 20X7

Cr Provision for repair expense (to be carried out in 20X8)

Hierarchy of decisions

The first stage

- Is to apply three-stage hierarchy of decisions
- The IASB Framework and most others, suggest that the first stage is to ask:
- Is there an asset/liability?
- not all asset and liabilities should be recognized!

Recognition

- The second stage is to ask
 - whether an asset or liability should be recognized in the balance sheet

- For example, the value of some asset may be so difficult to measure
- that they should be omitted from balance sheets

Recognition - The Framework (paragraph 83)

- gives recognition criteria for an asset as follows:
- (a) it is probable that any **future** economic **benefit**... will **flow** . . . to the enterprise and
- (b) the item has a cost or value that can be measured with reliability

Intangible assets (IAS 38)

- (a) Pre-operating expenses are not an asset,
 - because there is **no resource** with future
 benefit (paragraph 69).
- (b) Research expenditure can give rise to an asset but (if it is spent inside the entity) it is too difficult to demonstrate
 - that the benefits are probable for the expenditure to be recognized in a balance sheet (paragraph 54)

Intangible assets (IAS 38)

- (c) Development expenditure can give rise to an asset, which should be recognized
 - if, and only if, certain criteria are met –
 - such as there being a separately identifiable project that is technically feasible and commercially viable (paragraph 57)
- (d) Publicity cannot be capitalized
 - for the same reason as research cannot be (paragraph 69)

Views around the world

Views differ on these issues

For example:

- under the rules of the United States,
- even development expenditure cannot be recognized as an asset
- unless it relates to software

EU Fourth Directive

- A more general European example of problems
- concerning the recognition of assets
- can be seen
- in the list of items shown under
- the heading 'Assets' in the EU Fourth
 Directive

Balance sheet contents specified by the EU Fourth Directive

Assets		Capital and Liabilities
A	Subscribed capital unpaid*	A Capital reserves
В	Formation expenses	I Subscribed capital* II Share premium account
С	Fixed assets I Intangible assets II Tangible assets III Financial assets	III Revaluation reserve IV Reserves V Profit or loss brought forward VI Profit or loss for the year
D	Current assets I Stocks II Debtors III Investments IV Cash	B Provisions for liabilities and charges C Creditors D Accruals and deferred income* E Profit for the year*
Ε	Prepayments and accrued income	
F	Loss for the year'	

Notes:

- * Can be netted off, in which case the amount uncalled can be shown as an asset under A or D.II.
- * Can be shown under D.II.
- * Can be shown under reserves A.VI.
- * Can be shown as creditors under C.

Measurement

- If an asset or liability should be recognized,
- it is necessary to measure its value
- In most systems of accounting
 - initial recognition takes place at cost
- If this were not the case: this leads to recognition of a gain or loss

- It is obvious, such as
 - when a machine is bought for cash.
- However, even then, decisions have to be made about
 - what to do with taxes on the purchase,
 - delivery charges, and so on.
- The **cost** should include not only the **invoice price** of the asset
 - but also all **costs** involved in **getting** the asset into a **location** and **condition** where it can be **productive**

This will include (machinery, equipment):

- delivery charges,
- sales taxes and
- installation charges

(in the case of plant and machinery)

For land and **buildings** cost will include:

- legal fees,
- architect's fees
- clearing the land and so on,
- the builder's bill
- the cost of the land

Capitalization of costs

- If a company has used its own labour or materials to construct an asset,
- these should also increase the cost of the asset
 - rather than being treated as current expenses (they are *capitalized*)
- It is also possible to capitalize the interest cost on money borrowed to create fixed assets

If labour and material is capitalized

- certain formats of the income statement show this (capitalized) item as revenue.
- This is because
- all the labour and materials used
 - have been charged elsewhere in the income statement.

- Any payments
- that make the asset better
- than it was originally
- are capitalized: added to the asset!

Any other payments are expenses.

Expenses and improvements

In general,

- repairs and maintenance
- are treated as current expenses,
- improvements are capitalized

Expenses and improvements -example

- a new engine for a company vehicle will usually be treated as an expense,
 - since it keeps the vehicle in running order rather than improving it,
 - unless the engine is recorded as a separate asset.
- In contrast, the painting of advertising signs on the company's fleet of vans
 - may well be treated as capital item, if material in size.

Materiality

- the accountant needs to consider whether the amounts relating to the improvements are material enough to capitalize them.
- He or she tends to treat as much as possible as expense,
 - since this is the prudent and administratively more convenient method.
- this will also speed up tax deductibility

a list of six payments - example

Q: Which of these should be **added** to the **cost** of an asset,

and which should be treated as an immediate expense?

- repairs;
- decorating or redecorating;
- extensions;
- improvements;
- replacement of parts;
- future inevitable payments for dismantling, decommissioning or cleaning up.

a list of six payments - example

- Repairs: expense, they don't improve the asset
- Decorating costs might be capitalizable, if it is material in size
- The cost of building extensions
 - should normally be added to the asset being extended,
 - or could create a separately identified asset.
- Improvements should probably be capitalized.

a list of six payments - example

- Replacement of parts should be an expense
 - unless the part is treated as a separate depreciable asset,
 - so that replacement is treated as a disposal followed by a purchase.
- Future costs of dismantling, etc. should be discounted and added to the cost of the asset

Fair value

- Some purchases are not made with cash
- but in **exchange** for the **future payment** of cash or for exchange with other assets.

 the current 'fair value' of the purchase consideration should be estimated as accurately as possible.

Fair value in IFRS

the amount at which

- an asset could be exchanged,
- or a liability settled,
- between knowledgeable, willing parties
- in an arm's length legal transaction.

(an arm's length transaction: where the parties are not related)

Problem

- After initial recognition,
- whether to take account of subsequent changes in the value of an asset.
- For assets to be sold:
 - when, to take account of changes in value,
- the current value is recognized at the point of sale in the calculation of profit

Valuing an asset

- Conventional accounting in most countries
- continues to use cost
- as the basis for valuing most assets
- until the point of sale.

 Because its cheapness and greater reliability.

Historical cost

- is an easier and cheaper method of valuation
- Because it uses information already recorded and does not require expensive estimations
- for most assets the cost is more reliably determined than the fair value

Reliability vs relevance

Reliability is important (Framework)

- The Framework (paragraph 44) also suggests that regulators and preparers should be aware of the cost of the accounting,
 - to ensure that it does not exceed the benefits to the users

Reliability vs relevance - the problem

- the Framework's other key characteristic is relevance for economic decisions.
- It is difficult to see that the historical cost is the most relevant information for making decisions
 - which **normally** requires **estimation** of the future,
 - particularly the prediction of cash flows

Example

- Suppose, a company buys an investment for €800, in 2007. Its market value is €1000 at year end. It is sold for €850 in 2008.
- In order to give useful information, should the balance sheet show cost or market value at the end of 2007?

Example

It seems that the €800 cost is **not a very useful predictor** of cash flows at 31 December 20X7, **particularly if** the asset had been held for a **longer period.**

Also, if only cost is recorded until sale, then a **gain** of **€50** will be shown in 20X8 **even** though the **asset has fallen in value** in 20X8.

The **result** of management's decision **not to sell** asset early in 20X8 is **not reflected** in the **20X8 statements**.

The main asset valuation bases instead of cost

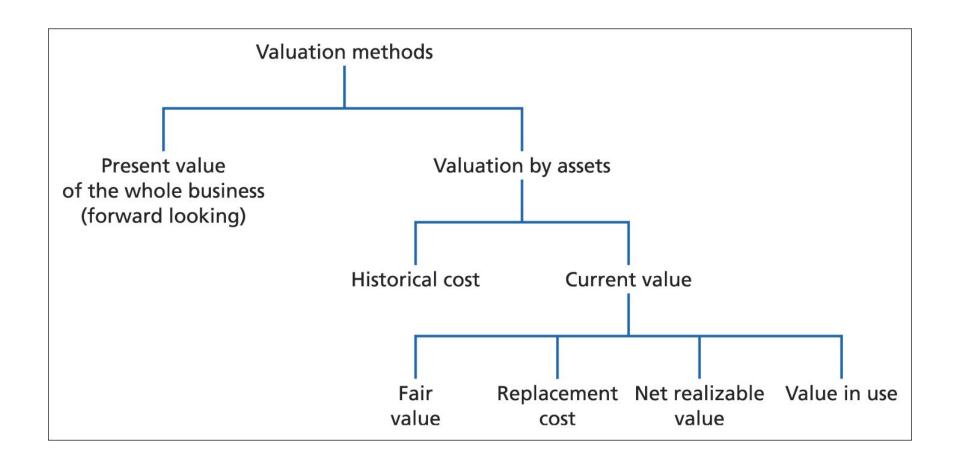
- fair value: assumes that the business is neither buying nor selling;
- replacement cost: takes account of the transaction costs of replacement;
- net realizable value: expected sales receipts less any costs to finish and to sell;
- value in use (or economic value): is the present value (discounted value) of the expected net cash flows from the asset

The main asset valuation bases instead of cost

 these values may be more relevant than past values,

 they involve much more subjectivity than historical cost valuations

Valuation methods



Choice of valuation methods

- Depends on who requires it
- Owners want more realistic estimate (going concern)
- Lenders may want a much more conservative valuation,
 - based on the **lowest** likely **valuation** of the individual assets
 - in the event that the business has to be closed down.

Choice of valuation methods

- Managers may be prepared to put up with more estimated numbers,
 - because they can trust themselves to estimate fairly.
- there is a need for reliability
- and therefore
- a difficult trade-off between relevance and reliability

conventional accounting

for most assets,

 the cheapness and reliability of historical cost has ensured its dominance,

doubts about relevance.

assets with active markets

such as some markets for shares

fair values are reliable.

 there seems a strong argument for the use of fair values in financial reporting.

Example

A company owns **two identical office blocks** next door to each other in the centre of Stockholm.

They are used as the company's head office.

Office 1 was bought in 1980 for €1m and Office 2 was bought very recently for €4m.

Under conventional accounting practice,

Office 1 will be shown at less than €1m because it has worn out (depreciated) to some extent since 1980.

The identical Office 2 will be shown at €4m.

Is this a fair presentation?

conventional accounting - example

It sometimes takes account of market values before the sale of assets.

- to be prudent, inventories are usually valued at the lower of cost and net realizable value,
- fixed assets are written down below cost if their value is impaired

Income recongition

 the recognition of income does not always need to await the receipt of cash;

that is, the accruals convention is used.

 the determination of the exact moment when income should be recognized is a practical problem.

EU laws

is expressed in terms of 'realization':
income should be recognized in the
income statement when it is realized.

In practice, this does not help much because there is no clear way to define what is realized,

(if it does not mean 'received in cash'.)

Defining 'realized'

One possibility is to define realized as

- having either received cash or
- a contractual right to cash.

 This allows income recognition before a customer pays a bill.

Example

- 12 January Buy raw materials; store them
- 19 February Begin work on processing the materials
- 3 April Finished goods produced; store them
- 10 May Receive order for goods; order accepted
- 17 May Goods delivered; customer invoiced
- 5 June Customer pays invoice for goods

Example

- It is clear that the eventual profit will be
- the difference between
- the final sales receipts
- and the various costs involved.

At what point should the income be recognized?

 Is the profit earned gradually over the manufacturing process,

or when a contract of sale is agreed,

or when the goods are delivered,

or when cash is finally paid?

Realization convention

- profits that have not been realized are not recorded
- income is not recognized until
- a sale has been agreed,
 - and possibly even later.

Realization convention

- income recognition usually occurs a little later:
- when control of the goods passes
- and the invoice is raised

(17 May in our example).

Definition of revenue

- (Framework, paragraph 70):
- Income is increases in economic benefits during the accounting period
- in the form of inflows or enhancements of assets or decreases of liabilities
 - that result in increases in equity

Income

 the Framework contrasts the word 'income' (rather than the word 'revenue') with the word 'expense'.

 The Framework uses the word 'revenue' to mean income from customers

Problems

1) practical problems for the **recognition** of **revenue** from the **sale** of **goods** and rendering of **services**; and

2) major **theoretical problems** of when to recognize the **gains** on **assets if** they are **revalued** in the balance sheet.

Problem 1

The IASB addresses it in IAS 18 Revenue:

revenue from the sale of goods is to be recognized when control and risks have passed to the customer.

Problem 2

- It is the problem of gains on unsold assets
- where a company owns listed equities that rise in value,
- it might seem relevant and reliable to record the assets in the balance sheet at the higher values.
- Are such gains to be treated as income?