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

Costs

Assets **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[1]	A Capital reserves
B Formation expenses	I Subscribed capital[1]
C Fixed assets	II Share premium account
I Intangible assets	III Revaluation reserve
II Tangible assets	IV Reserves
III Financial assets	V Profit or loss brought forward
D Current assets	VI Profit or loss for the year
I Stocks	B Provisions for liabilities and charges
II Debtors	C Creditors
III Investments	D Accruals and deferred income[4]
IV Cash	E Profit for the year[3]
E Prepayments and accrued income[2]	
F Loss for the year[3]	

Notes:

[1] Can be netted off, in which case the amount uncalled can be shown as an asset under A or D.II.
[2] Can be shown under D.II.
[3] Can be shown under reserves A.VI.
[4] 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**

Cost of an asset

- 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**

Cost of an asset

This will include (machinery, **equipment**):

- **delivery** charges,
- sales **taxes** and
- **installation** charges

(in the case of plant and machinery)

Cost of an asset

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 m**aterials** used
  - have been **charged elsewhere** in the income statement.

Cost of an asset

- 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

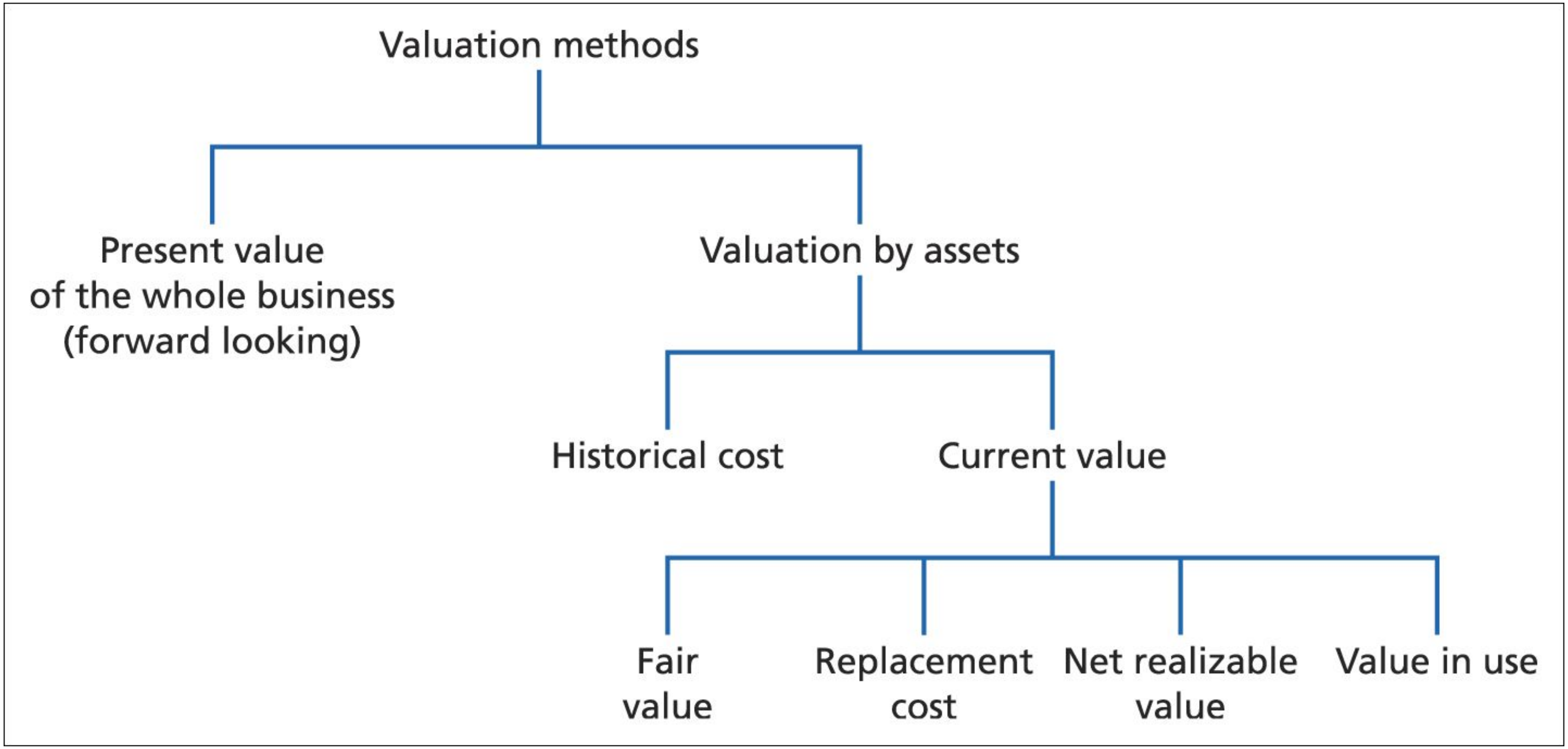
- ***fair value:*** assumes that the business is neither buying nor selling;
- ***replacement cost:*** takes account of the **transaction costs** of replacement;
- ***net realizable value:*** expected **sales receipts less** any **costs** to finish and to sell;
- ***value in use* (or *economic value):***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