



Accounting Standards Board

FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

This framework has been approved for issue by the Accounting Standards Board (ASB), which body has as its principal function to set generally recognised accounting practice as required by section 216(1) of the Constitution of the Republic of South Africa (Act 108 of 1996). In the development of this framework, reference was made to the following:

- the framework developed by the International Accounting Standards Committee (IASC), issued by the IASC in July 1988,
- the International Public Sector Accounting Standard on Presentation of Financial Statements issued by the International Federation of Accountant's Public Sector Committee,
- the Statement of Principles for Financial Reporting Entities issued by the Accounting Standards Board of the United Kingdom,
- the Proposed Interpretation for Public Benefit Entities issued by the Accounting Standards Board of the United Kingdom,
- Study 11 on Government Financial reporting issued by the International Federation of Accountant's Public Sector Committee, and
- Concepts Statement No. 1 of the Governmental Accounting Standards Board of the United States of America.



Accounting Standards Board

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Introduction

Purpose and status

- .1 This framework aims to set out the principles on which Standards of Generally Recognised Accounting Practice will be based when dealing with specific topics. The primary purpose of articulating these principles is to provide a coherent frame of reference to be used in the development of generally recognised accounting practice for the public sector and to assist preparers and auditors.
- .2 Accordingly, this framework sets out the concepts that underlie the preparation and presentation of financial statements for users. The purpose of the framework is to:
 - a. provide users of financial statements prepared in accordance with Standards of Generally Recognised Accounting Practice such as parliament, the legislatures and municipal councils, with information on the bases on which such financial statements are prepared and to assist them to assess whether proper stewardship was exercised;
 - b. assist preparers of financial statements in applying Standards of Generally Recognised Accounting Practice and in dealing with topics that have yet to form the subject of a Standard of Generally Recognised Accounting Practice;
 - c. assist auditors in forming an opinion as to whether financial statements conform with Standards of Generally Recognised Accounting Practice;
 - d. assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Standards of Generally Recognised Accounting Practice; and
 - e. provide the Board with a conceptual basis for the formulation of Standards of Generally Recognised Accounting Practice and assistance with their development.
- .3 The framework is intended to be relevant to the financial statements of any entity within the public sector, regardless of the size of the reporting entity and the nature of the service provided. An entity means one of the following:
 - a. departments (national or provincial);
 - b. public entities;
 - c. constitutional institutions;
 - d. municipalities and board, commissions, companies, corporations; funds or other entities under the ownership of a municipality; and
 - e. Parliament and the provincial legislatures.

It recognises that such entities normally have the rendering of services as the primary objective, rather than the provision of a financial return to the owners of the net assets. The term entity and 'reporting entity' are used interchangeably.

- .4 The term 'economic entity' is used to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.
- .5 Other terms sometimes used to refer to an economic entity include 'administrative entity', 'consolidated entity' and 'group'.
- .6 An economic entity may include entities with both social policy and commercial objectives. For example, a housing department may be an economic entity, which includes entities that provide housing for a nominal charge, as well as entities that provide accommodation on a commercial basis.
- .7 The term 'financial statements' used in this framework is intended to apply to the financial statements of the reporting entity and that of the economic entity, i.e. the consolidated financial statements.
- .8 This framework is not a Standard of Generally Recognised Accounting Practice and hence does not define standards for any particular measurement or disclosure issue, but a framework, which sets out the objectives, and concepts, which underlie the preparation and presentation of financial statements. Nothing in this framework overrides any specific Standard of Generally Recognised Accounting Practice.
- .9 The framework will be revised from time to time based on the Board's experience of working with it.

Scope

- .10 The framework deals with:
 - a. the objective of financial statements;
 - b. the qualitative characteristics that determine the usefulness of information in financial statements;
 - c. the definition, recognition and measurement of the elements from which financial statements are constructed.
- .11 The framework is concerned with general-purpose financial statements (hereafter referred to as financial statements) including consolidated financial statements. Such financial statements are prepared at least annually and are directed towards the common information needs of a wide range of users. Many users have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view.
- .12 An annual report consists of non-financial and financial information. The process of financial reporting comprises both financial statements and other financial information, including reporting on information required in terms of legislation and reports on the achievement of outputs and outcomes against pre-determined objectives. A complete set of financial statements normally includes a statement of financial position, a statement of financial performance, a statement of cash flows, a statement of changes in net assets, and those notes and other statements and explanatory material that are an integral part of the financial



statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about services and geographical segments and disclosures about the effects of changing prices. However, financial statements do not include such items as discussion and analysis and similar items that may be included in an annual report.

Users and their information needs

- .13 The users of financial statements include parliament, legislatures and other governing bodies, the public who receive the services and pay taxes and levies, present and potential funders and financial supporters, suppliers and creditors, rating agencies, other governments, international agencies, resource providers, economists, financial analysts and employees. They use financial statements in order to satisfy some of their diverse needs for information. These needs include the following:
- a. *Parliament, legislatures and other governing bodies.* Parliament, legislature and other governing bodies grant authority to reporting entities to administer public financial affairs and resources. They may use financial statements to assess the reporting entity's stewardship of resources, compliance with legislation, and its financial position and financial performance.
 - b. *National and Provincial Treasuries.* National Treasury and Provincial Treasuries who prepare consolidated financial statements for the government and uses the financial statements to assist Parliament and the legislatures to determine the appropriate allocation of resources in accordance with the approved budget.
 - c. *The public.* The public includes taxpayers, electors, voters, special interest groups, and recipients of goods, services and transfers provided or made by government. Taxpayers are required to provide resources to the government and other entities and are interested in information about how the funds have been used. They are also interested in information on whether the government is funding current goods and services out of current taxes collected.
 - d. *Funders and financial supporters.* Providers of resources are interested in information that helps them to assess how effectively government and relevant entities have fulfilled their stewardship roles. They are also interested in information about the utilisation of resources they supplied to the entity that might be useful in taking decisions about resources they may choose, or be required, to supply in future. Lenders are interested in information that enables them to determine whether their loans, and the interest earned on them, will be paid when due. Similarly, potential lenders are interested in information that helps them decide whether to lend to the entity and on what terms.
 - e. *Suppliers and creditors.* Suppliers and creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Creditors are likely to be interested in an entity

over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.

- f. *Rating agencies.* Government and entities obtain finance from the national and international capital markets by issuing bonds or other financial instruments. Rating agencies provide assessments of government and its entities' creditworthiness for the capital market using standard categories. Rating agencies are primarily concerned with a government and its entities' ability to service debt and to repay that debt when it falls due. Rating agencies therefore consider the nature and extent of other obligations, the asset backing of a government, the extent of its current and projected spending and its ability to generate the same or increased levels of revenue.
- g. *Other governments, international agencies and resource providers.* Governments and international agencies are interested in the allocation of resources and, therefore, the activities of entities. They are also interested in the effective use of resources provided by one sphere of government to another sphere of government. They also have a specific need for information, and compliance with their reporting requirements contributes to the standing of the country in the international community.
- h. *Economic and financial analysts.* Economic and financial analysts, including the media, review and analyse information on behalf of others with the purpose of assessing policy direction.
- i. *Senior management.* Although senior management are internal users and have access to more detailed internal reports, often the general external reports provide a useful overview of the financial affairs for these users.
- j. *Employees.* Employees and their representative groups are interested in information about the stability and sustainability of their employers. They are also interested in information, which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

- .14 While financial statements cannot meet all of the information needs of these users, there are needs that are common to all users. Since government, national and provincial treasuries, parliament and the legislatures have a direct interest; the provision of financial statements that meet their needs will also meet most of the needs of other users.

Assessing stewardship

- .15 Stewardship plays an important role in the use of financial statements of the public sector. Accountability for the use of public funds and the safekeeping of the entity's resources is of paramount importance. There may be a wide range of people who have an interest in these activities of an entity. Financial reporting plays a major role in fulfilling the duty to be publicly accountable for the collection of taxation and other revenue and its use in the rendering of public services. Therefore, a key objective of financial statements is the provision of information to enhance a user's assessment of proper stewardship. The assessment of stewardship will also indicate whether fiscal policies are sustainable over the long term.



- .16 Financial statements can only provide a partial answer on the efficient and effective use of funds and other resources, as they do not indicate the level or the quality of the goods and services, which have been provided. Performance reporting is an important aspect of public sector reporting, but is beyond the scope of this framework.
- .17 The accounting officer, accounting authority or municipal manager (included as management elsewhere in the framework) of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information required for it to carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this framework. Nevertheless, published financial statements are based on the information used by management about the financial position, financial performance and changes in net assets of the entity.
- .18 The term 'management' in this document refers those persons responsible for planning, directing and controlling the activities of the entity, including those charged with the governance of the entity in accordance with legislation, in instances where they are required to perform such functions.
- .19 Financial statements do not seek to meet all the information needs of users. Users will usually need to supplement the information they receive from financial statements with information from other sources. These inherent limitations mean that some specific financial information on the reporting entity can be provided only by financial reports other than general-purpose financial statements. Those users with the authority to obtain additional financial information might also utilise that authority to supplement the information in the financial statements.
- .20 In assessing stewardship of resources, the user is likely to need information in addition to that reported in a conventional presentation of financial performance and financial position. For example, information in the material accompanying the financial statements, such as the operating review and the review of programme performance is required in order to put the numerical information in the financial statements into context. Such information might include qualitative and quantitative information on services provided by the entity during the year.
- .21 Many entities also utilise other forms of presentation, which may include financial information and may or may not be provided with the financial statements. One example is a report on programme performance, which provides information on whether an entity has fulfilled its spending mandates and achieved its performance objectives. Many entities might also use methods of communication other than the financial statements to provide financial information.



Accountability

- .22 Accountability is the cornerstone of financial reporting in government, and the term *accountability* is used throughout this framework. Accountability is based on the belief that the citizens has a "right to know," a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives. Financial reporting plays a major role in fulfilling government's duty to be publicly accountable in a democratic society.
- .23 Public sector entities impose taxes and provide services. The taxes imposed and services provided by public sector entities possess characteristics that need to be considered when developing financial reporting objectives, bearing in mind those taxpayers cannot choose whether or not to pay taxes. Neither is there a proportional relationship between the amount of taxes paid, nor to the cost or value of the services received by the individual. These characteristics highlight the need for public accountability.
- .24 At a minimum, accountability through financial reporting includes providing information to assist in evaluating whether the government has operated within the legal constraints imposed by the citizens. The structure of government, the nature of the resource providers, and the political process are characteristics of the environment that underscore the need for accountability.

The objective of financial statements

- .25 The financial reporting objectives set forth in this framework are:
- a. Financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable users to assess that accountability by:
 - i. Providing information to determine whether current year revenues were sufficient to meet the cost of providing current year services rendered.
 - ii. Demonstrating whether resources were obtained and used in accordance with the entity's legally adopted budget, and demonstrating compliance with other finance-related legal or contractual requirements.
 - iii. Providing information to assist users in assessing the service efforts, costs, and accomplishments of the entity.
 - b. Financial reporting should assist users in evaluating the operating results of the entity for the year by:
 - i. Providing information about sources and uses of financial resources.
 - ii. Providing information about how it finances its activities and meet its cash flow requirements.
 - iii. Providing information necessary to determine whether its financial position improved or deteriorated as a result of the year's operations.



- c. Financial reporting should assist users in assessing the level of services that can be provided by the entity and its ability to meet its obligations as they become due by:
 - i. Providing information about its financial position and condition.
 - ii. Providing information about its physical and other non-financial resources having useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources.
 - iii. Disclosing legal or contractual restrictions on resources and the risk of potential loss of resources.

- .26 The objective of financial statements is to provide information about the financial position, financial performance, cash flows and changes in net assets of an entity that is useful to a wide range of users. Financial statements also show the results of the stewardship of management, and the accountability of management for the resources entrusted to it.
- .27 Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.

Financial position, financial performance, cash flows and changes in net assets

- .28 The decisions that are taken by users of financial statements require an evaluation of the ability of an entity to implement sustainable service delivery and of the timing and certainty of their delivery.
- .29 Information about the financial performance of an entity provides an account of stewardship of management and is useful in assessing the past and anticipated financial performance of the entity. Information about variability of financial performance is important in this respect. Information about financial performance is useful in holding management to account for the safekeeping of the entity's resources and for their proper and efficient use. It is also useful in forming judgements about the effectiveness with which the entity might employ additional resources.
- .30 The financial position of an entity is affected by the resources it controls, its financial structure, its liquidity and sustainability, and its capacity to adapt to changes in the environment in which it operates. Information about the resources controlled by the entity and its capacity in the past to modify these resources is useful in predicting the ability of the entity to sustain its service delivery in the future. Information about financial structure is useful in predicting future financing and borrowing needs; it is useful in assessing the entity's ability to raise further finance. Sustainability refers to the ability to continue to provide the services in the longer term.

- .31 Liquidity refers to the availability of cash in the near future after taking account of financial commitments over this period. Information about liquidity is useful in predicting the ability of the entity to meet its financial commitments as they fall due.
- .32 The liquidity and sustainability of a national or provincial department is very much dependent on their budget allocation. Their financial position is therefore primarily affected by the budget whereas a municipality relies largely on their own revenue in the form of rates and taxes and other service charges.
- .33 Information concerning changes in the cash flows of an entity is useful in order to assess its investing, financing and operating activities during the reporting period. This information is useful in providing the user with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows.
- .34 Information about financial position is primarily provided in a statement of financial position. Information about financial performance is primarily provided in a statement of financial performance. Information about cash flows is provided in the financial statements by means of a statement of cash flows. Changes in the residual (after deducting liabilities from assets) are provided in the statement of net assets.
- .35 The component parts of the financial statements interrelate because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose or provide all the information necessary for particular needs of users. For example, a statement of financial performance provides an incomplete picture of financial performance unless it is used in conjunction with the statement of changes in net assets and the statement of cash flows.

Notes and supplementary schedules

- .36 The financial statements also contain notes, supplementary schedules, and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the statement of financial position and statement of financial performance. They may include disclosures about the risks and uncertainties affecting the entity and any resources and obligations not recognised in the statement of financial position. Information about service segments and the effect on the entity of changing prices may also be provided in the form of supplementary information.

Underlying assumptions

Accrual basis

- .37 In order to meet the stated objectives listed in paragraphs .25 - .27, financial statements should be prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent are received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual



basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash and/or deliver services in the future and of resources that represent cash to be received and/or potential to deliver services in the future. Hence, they provide the type of information about past events and other transactions that is most useful to users to assess the responsibility for accountability of government.

Going concern

- .38 The financial statements should be prepared on the assumption that an entity is a going concern, and will continue in operation for the foreseeable future. Financial problems of public sector entities are normally resolved by either the ability to raise taxes or some other intervention in order to ensure the services are maintained. Accordingly, a consideration of the going concern involves judgement on whether the entity will continue in its present or some modified form. Only on rare occasions will the activities cease altogether e.g., when the government discontinues a guarantee of debt and no other intervention is proposed for the entity to continue as a going concern. In those circumstances, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Qualitative characteristics of financial statements

- .39 Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

- .40 An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of government, the entity's activities and environment, accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the decision-making needs of users should not be excluded merely because it may be too difficult for certain users to understand.
- .41 When considering the capability of users of the financial statements, it may not always appear appropriate to assume that they will have a reasonable knowledge of accountability, stewardship and political objectives. However, if financial statements are to be useful to a wide range of users for general purposes, the preparers must be able to assume a reasonable knowledge. In this regard, an important role is played by intermediaries, such as oversight and regulatory bodies, who often work on behalf of users such as taxpayers and donors in assessing the financial performance of an entity and its management. In these circumstances, the capabilities of users might be determined by reference to the expected capabilities of the intermediary.

Relevance

- .42 To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences proper stewardship by helping users to evaluate past, present or future events or confirming, or correcting, their past evaluations.
- .43 The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the entity to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the entity would be structured or the outcome of planned operations.
- .44 Information about financial position and past financial performance is frequently used as the basis for predicting future financial position and financial performance and other matters in which users are directly interested. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the information value of the statement of financial performance is enhanced if items of revenue or expense that are of significant size, nature or incidence are separately disclosed.
- .45 In the public sector, the aim of legislation is to ensure that budgets are balanced and debts are limited with a view to achieving fairness from one year, one term of office, or one generation to another. In short, financial reporting should help users assess whether current year revenues are sufficient to pay for the services provided that year, and whether future taxpayers will be required to assume burdens for services previously provided.

Materiality

- .46 The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new programme or service segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the entity.
- .47 Information is material if its omission, misstatement, or non-disclosure could influence the decisions of users made on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission, misstatement, or non-disclosure in the financial statements. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Reliability

- .48 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.
- .49 Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the entity to recognise the full amount of the claim in the statement of financial position, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful representation

- .50 To be reliable, information must represent faithfully the transactions and other events it purports to either represent, or could reasonably be expected to represent. Thus, for example, a statement of financial position should represent faithfully the transactions, conditions and other events that result in assets, liabilities and net assets of the entity at the reporting date which meet the recognition criteria.
- .51 Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties, either in identifying the transactions and other events to be measured, or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although public entities generate intangible assets internally over time, it is usually difficult to identify or measure that intangible asset reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance over form

- .52 If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits or service potential embodied in the asset. An example of such a transaction may include a public-private-partnership to manage a road. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

Neutrality

- .53 To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

- .54 The preparers of financial statements do have to contend with the uncertainties that inevitably, surround many events and circumstances, such as the collectability of doubtful receivables and the probable useful life of plant and equipment. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or revenue are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or revenue, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Completeness

- .55 To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Comparability

- .56 Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and financial performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, financial performance and changes in net assets. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.
- .57 An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same entity from period to period and by different entities. Compliance with Standards of Generally Recognised Accounting Practice, including the disclosure of the accounting policies used by the entity, helps to achieve comparability.
- .58 The need for comparability should not be confused with mere uniformity over time and should not be allowed to become an impediment to the introduction of improved accounting policies. It is not appropriate for an entity to continue accounting in the same manner for a transaction or other event if the policy

adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an entity to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

- .59 Because users wish to compare the financial position, financial performance and changes in net assets of an entity over time, it is important that the financial statements show corresponding information for the preceding period(s). Comparatives assist in the evaluation of performance.

Constraints on relevant and reliable information

Timeliness

- .60 If there is undue delay in the reporting of information, it may lose its relevance. However, timeliness of reporting is prescribed by legislation, but where management has applied for the appropriate extensions, if any, they may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

Balance between benefit and cost

- .61 The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Users other than those for whom the information is prepared may also enjoy benefits; for example, the provision of further information to suppliers may reduce the purchasing costs of an entity. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between qualitative characteristics

- .62 In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement.

Fair presentation

- .63 Financial statements are frequently described as presenting fairly, the financial position, financial performance and changes in net assets of an entity. Although this framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards

normally results in financial statements that convey what is generally understood as a fair presentation of such information.

The elements of financial statements

- .64 Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the statement of financial position are assets, liabilities and net assets. The elements directly related to the measurement of financial performance in the statement of financial performance are revenue and expenses. The statement of cash flows usually reflects statement of financial performance elements and changes in statement of financial position elements; accordingly, this framework identifies no elements that are unique to this statement.
- .65 The presentation of these elements in the statement of financial position and the statement of financial performance involves a process of sub-classification. For example, assets and liabilities are classified by their nature or function in the entity in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial position

- .66 The elements directly related to the measurement of financial position are assets, liabilities and net assets. These are defined as follows:
- a. An asset is a resource controlled by the entity as a result of past events and from which future economic benefits or service potential is expected to flow to the entity.
 - 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 or service potential.
 - c. Net assets are the residual interest of the owners in the assets of the entity after deducting all its liabilities. (The term “owners” is explained in more detail in paragraph .94.)
- .67 The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the statement of financial position. Thus, the definitions embrace items that are not recognised as assets or liabilities in the statement of financial position because they do not satisfy the criteria for recognition discussed in .111 - .122. In particular, the expectation that future economic benefits or service potential will flow to or from an entity must be sufficiently certain to meet the probability criterion in paragraph .116 before an asset or liability is recognised.
- .68 In assessing whether an item meets the definition of an asset, liability or net assets, attention needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the

economic benefits or service potential of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to an item that satisfies the definition of an asset and a liability and these are recognised as such in the lessee's statement of financial position.

Assets

- .69 Assets provide a means for entities to achieve their objectives. Assets that are used to deliver goods and services in accordance with an entity's objectives but which do not directly generate net cash inflows are often described as embodying "service potential". Assets that are used to generate net cash inflows are often described as embodying "future economic benefits". To encompass all the purposes to which assets may be put, this framework uses the term "future economic benefits or service potential" to describe the essential characteristic of assets.
- .70 The future economic benefit or service potential embodied in an asset is the potential to contribute directly or indirectly, to the flow of cash and cash equivalents to the entity or to the rendering of services by the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative method of service delivery, reduces the cost of delivering services.
- .71 An entity usually employs its assets to provide goods or services capable of satisfying the wants or needs of beneficiaries. Furthermore, in many cases, assets are used to provide goods or services to beneficiaries or customers that are free or subsidised. An item can meet the definition of an asset if it is used either directly or indirectly to provide goods and/or services that are used in furtherance of an entity's objectives. Cash itself renders a service to the entity because of its command over other resources.
- .72 The future economic benefits or service potential embodied in an asset may flow to the entity in a number of ways. For example, an asset may be:
- used singly or in combination with other assets in the production of goods or services to the benefit of the entity's beneficiaries;
 - exchanged for other assets;
 - used to settle a liability; or
 - distributed to the owners of the entity. (The term "owners" is explained in more detail in paragraph .94.)
- .73 Many assets, for example, property, plant and equipment have a physical form. However, physical form is not essential to the existence of an asset; hence, mineral rights, patents and copyrights, for example, are assets if future economic benefits or service potential is expected to flow from them to the entity and if they are controlled by the entity.

- .74 Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits, which are expected to flow from the property. Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of 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 an entity controls the benefits that are expected to flow from it.
- .75 Entities that have custody of an asset may not have all the legal powers of ownership, such as the ability to sell the item. There may also be restrictions on the entity's use of the asset. However, this does not necessarily mean that the entity does not control access to future economic benefits or service potential. To satisfy the requirement for control, the entity does not need unlimited power over the physical item. Instead, it is the rights or access to future economic benefits or service potential that need to be controlled.
- .76 The requirement that the rights or other access should be controlled by the entity treating them as its assets means that a particular right or other access to future economic benefits or service potential will appear in only one set of single entity financial statements, because such rights or access can be directly controlled by only one entity.
- .77 The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include property received by an entity from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or events expected to occur in the future in themselves do not give rise to assets; hence, for example, an intention to purchase inventory of itself, does not meet the definition of an asset.
- .78 There is a close association between incurring expenses and generating assets but the two do not necessarily coincide. Hence, when an entity incurs expenses, this may provide evidence that future economic benefits or service potential were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expense does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the statement of financial position; for example, items that have been donated to the entity may satisfy the definition of an asset.
- .79 To the extent that an asset is not expected to be utilised in the foreseeable future, it is likely to have suffered impairment. Impairment is a loss in the future economic benefits or service potential of an asset, over and above the systematic recognition of the loss of the asset's future economic benefits or service potential through depreciation. Impairment, therefore, reflects a decline in the utility of an asset to the entity that controls it.

Liabilities

- .80 An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement, i.e. the entity has no realistic alternative to avoid the outflow of economic resources or service potential. This is normally the case, for example, with amounts payable for services rendered and goods received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good relations or act in an equitable manner.
- .81 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. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of an order of court, leave the entity with no realistic alternative to avoid the outflow of resources to another party.
- .82 Governments make, and amend, general promises and policies as part of the ongoing political processes. Consideration should be given to such promises to determine if, and when, such promises have given rise to a present obligation and/or a future commitment.
- .83 The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits or service potential in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:
- a. payment of cash;
 - b. transfer of other assets;
 - c. provision of services;
 - d. replacement of that obligation with another obligation; or
 - e. conversion of the obligation to net assets.
- .84 An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.
- .85 Liabilities result from past transactions or other past events.
- .86 Sometimes a series of events will have to take place before the entity will have an obligation to transfer economic benefits or service potential. In such circumstances, whether the obligation exists depends on whether any events that have still to take place are under the entity's control. If they are, the entity has a realistic alternative to avoid the transfer, so no obligation exists. For example, as long as it has a realistic alternative to avoid a penalty clause in a contract by performing, a liability in respect of the penalty will not arise.

- .87 Some liabilities can be measured only by using a substantial degree of estimation, sometimes described as provisions. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. Examples include provisions for payments to be made under an obligation to pay social benefits and provisions to cover pension obligations.

Net assets

- .88 Residual interest of the owners is the amount found by deducting all of the entity's liabilities from all of the entity's assets. The term "owners" is explained in more detail in paragraph .94.
- .89 "Net assets" is the term used in this framework to refer to the residual measure in the statement of financial position (assets less liabilities). Net assets may be positive or negative. Other terms may be used in place of net assets, provided that their meaning is clear.
- .90 Although net assets are defined in paragraph .66 as a residual, it may be sub-classified in the statement of financial position. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its net assets.
- .91 The creation of reserves is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection from the effects of future losses. The existence and size of these legal, statutory and tax reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are deemed to be appropriations of retained earnings, and not expenses. Any such transfers are disclosed in the statement of changes in net assets.
- .92 The distinction between liabilities and residual interest is highly significant. Creditors have the ability to insist that a transfer of economic benefit or service potential is made to them regardless of the circumstances. Most entities in the public sector are owned by other government entities or by the public as a constituency or the community as a whole. These owners frequently do not have the right to participate in a distribution of the net assets.
- .93 The amount at which net assets is shown in the statement of financial position is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of net assets will not necessarily correspond with the fair value of net assets or the sum that could be raised by disposing of, either the net assets on a piecemeal basis, or the entity as a whole on a going concern basis.

Contributions from owners

- .94 Contributions from owners means future economic benefits or service potential that has been contributed to the entity by parties external to the entity, other than those that result in liabilities of the entity, that establish a financial interest in the net assets of the entity, which:



- (a) Conveys entitlement both to distributions of future economic benefits or service potential by the entity during its life, such distributions being at the discretion of the owners or their representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or
- (b) Can be sold, exchanged, transferred or redeemed.”

.95 Transactions with owners that are not entered into in their capacity as owners, as defined, result in revenue for the recipient and expenses for the donor.

Distributions to owners

.96 Distributions to owners are decreases in residual interest resulting from transfers to owners in their capacity as owners.

Financial performance

.97 Surplus or deficit is frequently used as a measure of financial performance or as the basis for other measures, such as return on investment. The elements directly related to the measurement of surplus or deficit is revenue and expenses.

.98 The elements of revenue and expenses are defined as follows:

- a. Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets, other than increases relating to contributions from owners.
- b. Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets, other than those relating to distributions to owners.

.99 The definitions of revenue and expenses identify their essential features but do not attempt to specify the criteria that would need to be met before they are recognised in the statement of financial performance. Criteria for the recognition of revenue and expenses are discussed in paragraphs .111 - .122.

.100 Revenue and expenses may be presented in the statement of financial performance in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of revenue and expenses that arise in the course of the operating activities of the entity, and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to deliver service and/or generate cash and cash equivalents in the future; for example, incidental activities such as a gain made on the disposal of an asset is unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the nature of the entity and its operations. Items that arise from the operating activities of one entity may be unusual in respect of another.

- .101 Distinguishing between items of revenue and expense and combining them in different ways also permits several measures of entity financial performance to be presented.

Revenue

- .102 The definition of revenue encompasses both revenue and gains. Revenue arise in the course of the operating activities of an entity, and are referred to by a variety of different names including revenue from taxation, transfers (including appropriations and grants), interest, dividends and royalties.
- .103 Gains represent other items that meet the definition of revenue and may, or may not, arise in the course of the operating activities of an entity. Gains represent increases in economic benefits or service potential and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this framework.
- .104 Gains include, for example, those arising on the disposal of non-current assets. The definition of revenue also includes unrealised gains; for example, those arising on the revaluation of financial instruments and those resulting from increases in the carrying amount of long-term assets. When gains are recognised in the statements of financial performance or the statement of changes in net assets, they are usually displayed separately because knowledge of them is useful for the making of economic decisions.
- .105 Various kinds of assets may be received or enhanced by revenue; for example cash, may be received for services rendered and goods supplied or taxes due and payable. Revenue may also result from the settlement of liabilities. For example, a lending entity may receive goods or services in settlement of a present obligation to repay an outstanding loan. Revenue also results from the sharing of revenue collected by one sphere of government and paid transferred to another sphere of government, also known as 'appropriations', 'grants' or 'equitable share'.

Expenses

- .106 The definition of expenses encompasses losses as well as those expenses that arise in the course of the operating activities of the entity. Expenses that arise in the course of the operating activities of the entity include, for example, cost of sales or cost of services rendered, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment.
- .107 Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the operating activities of the entity. Losses represent decreases in economic benefits or service potential and as such, they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this framework.
- .108 Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, for example, those arising

from the effects of increases in the rate of exchange for a foreign currency in respect of the borrowings of an entity in that currency. When losses are recognised in the statement of financial performance, they are usually displayed separately because knowledge of them is useful for the making of economic decisions. Losses are often reported net of related revenue to reflect the substance of the transaction or event.

Recognition of the elements of financial statements

.109 Recognition is the process of incorporating in the statement of financial position or statement of financial performance an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph .110. It involves the depiction of the item in words, and in monetary amounts, and the inclusion of those amounts in the statement of financial position or statement of financial performance totals. Items that satisfy the recognition criteria should be recognised in the statement of financial position or statement of financial performance. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material. The Standards of Generally Recognised Accounting Practice will specify the appropriate recognition criteria to use for a specific element.

.110 The recognition process has the following stages:

- a. initial recognition, which is when an item is depicted in the primary financial statements for the first time;
- b. subsequent remeasurement, which involves changing the amount at which an already recognised asset or liability is stated in the primary financial statements; and
- c. derecognition, which is when an item that was previously recognised ceases to be recognised.
- d. An item that meets the definition of an element should be recognised if:
 - it is probable that any future economic benefit or service potential associated with the item will flow to or from the entity; and
 - the item has a cost or value that can be measured reliably.

.111 In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraphs .46 and .47. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, revenue or a liability.

.112 The recognition process requires that all events and conditions that may have an effect on the elements of the financial statements are, as far as possible, identified and reflected in an appropriate manner in the financial statements.

- .113 Transactions are the most common form of such events and are therefore the most common reason for recognising and derecognising items. Events other than transactions may nevertheless also result in the recognition or derecognition of items. For example, events such as discovery may result in the creation of new assets that may meet the recognition criteria. Events (such as a fire) that cause damage to an asset may result in a need to derecognise the asset or liability involved.

The probability of future economic benefit or service potential

- .114 The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits or service potential associated with the item will flow to or from the entity. The concept is in keeping with the uncertainty that characterises the environment in which an entity operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits or service potential are made based on the evidence available when the financial statements are prepared. For example, when it is probable that a receivable owed by an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits or service potential is recognised.

Reliability of measurement

- .115 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs .48 to .55 of this framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the statement of financial position or statement of financial performance. For example, the expected proceeds from a lawsuit may meet the definitions of assets and revenue, as well as the probability criterion for recognition. However, if it is not possible for the claim to be measured reliably, it should not be recognised as an asset or as revenue; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.
- .116 An item that, at a particular point in time, fails to meet the recognition criteria in paragraph .110 may qualify for recognition later, because of subsequent circumstances or events.
- .117 An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary schedules. This is appropriate when knowledge of the item is considered relevant to the evaluation of the financial position, financial performance and changes in net assets of an entity by the users of financial statements.

Recognition of assets

- .118 An asset is recognised in the statement of financial position when it is probable that the future economic benefits or service potential will flow to the entity and the asset has a cost or value that can be measured reliably.
- .119 An asset is not recognised in the statement of financial position when expenses have been incurred for which it is considered improbable that economic benefits or service potential will flow to the entity beyond the current reporting period. Instead, such a transaction results in the recognition of an expense in the statement of financial performance. This treatment does not imply either that the intention of management in incurring expenses was other than to generate future economic benefits or service potential for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits or service potential will flow to the entity beyond the current reporting period is insufficient to warrant the recognition of an asset.

Recognition of liabilities

- .120 A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits or service potential will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Derecognition

Derecognition because the asset or liability has been eliminated

- .121 Assets tend, in due course, to be consumed, transferred or otherwise disposed of, or they expire. Similarly, liabilities tend to be settled, extinguished, transferred, or they expire. In such circumstances, it may be necessary to derecognise some or all of the asset or liability involved.
- .122 Some transactions leave intact certain of the rights to future benefits inherent in an asset (or present obligations inherent in a liability) while eliminating others. In such circumstances, analysis is required to ascertain whether the effect of the transaction should be reflected by derecognising some or all of the assets and liabilities involved.
- .123 Ideally, an asset or liability would be derecognised as soon as it has been eliminated. However, there will sometimes be uncertainty about an item's continued existence. In such circumstances, derecognition will not take place until sufficient evidence exists that the transaction or other event has resulted in the elimination of the item. When there is uncertainty, prudence usually requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets than is required for liabilities. This tends to mean that, if there is any significant uncertainty about an asset's continued existence, it will be

derecognised. However, in the case of a liability, more evidence of its elimination will be needed before it will be derecognised.

Derecognition because the criteria for recognition are no longer met

.124 It is possible that although there has been no significant change in the inherent nature of an already recognised asset or liability – in other words, although the asset or liability has not been eliminated – the criteria for recognition are no longer met. For example, an event may have created additional uncertainty and, as a result, a previously recognised asset or liability can no longer be measured with sufficient reliability. On the rare occasions when this is the case, that asset or liability will be derecognised even though it has not been eliminated.

Recognition of revenue

.125 Revenue is recognised in the statement of financial performance when an increase in future economic benefits or service potential related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of revenue occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a provision of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

.126 The procedures normally adopted in practice for recognising revenue, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this framework. Such procedures are generally directed at restricting the recognition as revenue to those items that can be measured reliably and have a sufficient degree of certainty.

.127 Assuming that no contribution from owners is involved:

- a. if the effect of a transaction or other event is to increase the entity's recognised net assets, revenue will be recognised; and
- b. an expense will be recognised if, and to the extent that, previously recognised assets have been reduced, eliminated, or ceased to qualify for recognition as assets without a commensurate increase in other assets or reduction in liabilities. Similarly, an expense will be recognised when, and to the extent, that a liability is incurred or increased without a commensurate increase in recognised assets or a reduction in other liabilities.

.128 However, although the starting point for the recognition process may be the effect on assets and liabilities, the notions of matching and the critical event in the operating cycle will often help in identifying these effects.

Matching

.129 Matching has two forms:

- a. Time matching involves the recognition of receipts (and payments) directly associated with the passage of time as revenue (and expenses) on a systematic basis over the course of the period involved.

- b. Revenue / expenses matching involves the recognition of expenses directly associated with the generation of specific revenue as an expense in the same period as the revenues are recognised, rather than in the period in which the expenses is incurred.
- .130 Almost all expenses are undertaken with a view to acquiring some form of benefit in exchange. In reverse, the same concept applies to revenue. Consequently, if matching were used in an unrestricted way, it would be possible to delay the recognition in the statement of financial performance of most items of expenses insofar as the hoped-for benefits still lie in the future. The framework imposes a degree of discipline on this process because only items that meet the definitions of, and relevant recognition criteria for, assets, liabilities or residual interest are recognised in the statement of financial position. This means that the framework does not use the notion of matching as the main driver of the recognition process.
- .131 However, the application of the matching concept does not allow the recognition of items in the statement of financial position, which do not meet the definition of assets and liabilities.

Recognition of expenses

- .132 Expenses are recognised in the statement of financial performance when a decrease in future economic benefits or service potential related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).
- .133 Expenses are recognised in the statement of financial performance on the basis of a direct association between the costs incurred and the earning of specific items of revenue. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous, or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events. For example, the various components of expense making up the cost of goods sold are recognised at the same time as the revenue derived from the provision of the goods.
- .134 When economic benefits or service potential are expected to arise over several reporting periods and the association with revenue can only be broadly or indirectly determined, expenses are recognised in the statement of financial performance on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the consumption of assets such as property, plant, equipment, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the reporting periods in which the economic benefits or service potential associated with these items are consumed or expire.

- .135 An expense is recognised immediately in the statement of financial performance when expenses produce no future economic benefits or service potential or when and to the extent that, future economic benefits or service potential do not qualify, or cease to qualify, for recognition in the statement of financial position as an asset.
- .136 An expense is also recognised in the statement of financial performance in those cases when a liability is incurred without the recognition of an asset, for example, when a liability under a court ruling arises.

Measurement of the elements of financial statements

- .137 Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of financial performance. This involves the selection of the particular basis of measurement. The Standards of Generally Recognised Accounting Practice will specify the appropriate measurement basis to use for a specific element.
- .138 A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:
 - a. Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances, at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of operations.
 - b. Current replacement cost. The cost the entity would incur to replace the asset. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
 - c. Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal, less the estimated costs of completion and the estimated costs necessary to make the sale, exchange or distribution. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of operations.
 - d. Present value. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of operations. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of operations.
 - e. Market value. The amount obtainable from the sale or payable on the acquisition of an asset in an active market.
 - f. Fair value. The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

- .139 The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, financial instruments may be carried at fair value and pension liabilities are carried at their present value.
- .140 Subsequent measurement will occur if it is necessary to ensure that:
- assets measured at historical cost are carried at the lower of cost and recoverable amount;
 - monetary items denominated in foreign currency are carried at amounts based on prevailing exchange rates at reporting date; and
 - assets and liabilities measured on the current replacement cost are carried at prevailing current replacement values at the reporting date.

Such remeasurements, however, will be recognised only if:

- there is sufficient evidence that the monetary amount of the asset or liability has changed; and
- the new amount of the asset or liability can be measured with sufficient reliability.

Mixed measurement bases

- .141 Assets and liabilities have several different monetary attributes that could be represented in financial statements. The single most important characteristic that distinguishes these monetary attributes (which are known as measurement bases) is whether they are based on historical cost or current replacement cost.
- .142 The mixed measurement system permits the measurement basis to be selected separately for each category of assets or liabilities. It also permits the use of historical cost (or current replacement cost) for all assets and liabilities if historical cost (or current replacement cost) is the most appropriate measure for each of those categories. Thus, it can be adapted to fit the particular circumstances involved.
- .143 The framework therefore envisages that the mixed measurement system will be used and it focuses on the mix of historical cost and current replacement cost to be adopted.

Choosing a measurement basis and deciding whether to change it

- .144 In choosing the measurement basis to be used for a particular category of assets or liabilities, the aim is to select the basis that is most appropriate bearing in mind:
- the objective of financial statements and the qualitative characteristics of financial information, in particular relevance and reliability;
 - the nature of the assets or liabilities concerned; and
 - the particular circumstances involved.

.145 Although these factors may not change, the measurement basis that best meets them may. For example, measurement bases that were once thought unreliable may become reliable.

Discounting

.146 Historical cost and current replacement cost are both market prices and will therefore, generally take into account the time value of money, which takes into account the risk, associated with the future expected cash flows. Accordingly as stated in paragraph .138, no adjustment is made for the time value of money when using historical cost, current replacement cost and realisable value, while present value does take time value of money into account.