

AN INTRODUCTION TO THE

STATEMENT OF PRINCIPLES FOR FINANCIAL REPORTING

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PART 1—INTRODUCTION

1 The Accounting Standards Board's Statement of Principles for Financial Reporting plays a fundamental role in standard-setting here in the UK and the Republic of Ireland. Not surprisingly, therefore, there is much interest in it. This note has been prepared in response to that interest. It is intended to help those approaching the Statement for the first time to understand the context in which the Statement has been prepared. It also provides a brief overview of the main principles in the Statement.

2 Overviews involve simplification, so those wishing to use the principles and explanations in the Statement should refer to the Statement itself rather than to this note.

3 The Statement of Principles for Financial Reporting was published in December 1999 by the Accounting Standards Board. It can be purchased, £15.00 post-free, from:

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4 This introductory note was prepared in December 1999 and is available only as a downloadable document from the ASB's Website at www.asb.org.uk.

PART 2—QUESTIONS AND ANSWERS

Status and purpose of the Statement

1 What is the Statement of Principles for Financial Reporting?

It is a description of the fundamental approach that the Accounting Standards Board (the ASB) believes should, in principle, underpin the financial statements of profit-oriented entities. The Statement is intended to be a comprehensive and reasonably detailed description of that approach, and the approach itself is intended to be internally consistent, up-to-date and in line with the approaches adopted elsewhere in the world.

2 Is the Statement an accounting standard?

No. The Statement describes fundamental principles, but does not contain requirements on how financial statements should be prepared or presented. Company accounts will continue to be prepared under the requirements of company law and accounting standards.

3 What impact will the Statement have on accounting practice?

Its primary purpose is to provide a frame of reference to help the ASB itself in developing new accounting standards and reviewing existing ones. Its main impact on accounting practice will therefore be through its influence on the standard-setting process.

It is, however, only one of the factors that is taken into account in developing and reviewing standards: other factors include legal requirements, implementation issues, industry-specific issues, cost-benefit considerations and the desirability of evolutionary change. Furthermore, experience shows that the influence of these other factors may result in an accounting standard adopting an approach that is different from the approach suggested by the Statement.

The ASB has also made it clear that there will be plenty of opportunities to test the role that the Statement is playing in the development of any particular accounting standard because the ASB will continue to publish Discussion Papers and exposure drafts—even if the issue involved is dealt with fully in the Statement. The ASB expects there to be, and will allow time for, a healthy and spirited debate over all its future proposals.

Although the Statement's main impact on accounting practice will be through its influence on the standard-setting process, it may also influence practice by helping preparers and auditors faced with new or emerging accounting issues to carry out an initial analysis of the issues involved.

The approach adopted in preparing the Statement

4 What is the relationship between the true and fair view requirement and the Statement?

The concept of a true and fair view is fundamental to the whole system of financial reporting and represents the ultimate test of financial statements.

As accounting standards are an important influence on the meaning of true and fair and the Statement plays an important role in the development of those standards, the Statement has the true and fair concept at its foundation. Its insistence on financial information being relevant, reliable, understandable and comparable is just one example of this. The Statement does not, however, attempt to define the meaning of true and fair.

5 The Statement is not consistent in all respects with the accounting requirements of companies legislation. Why isn't that a problem for a statement that is supposed to be a frame of reference for standard-setting?

The inconsistencies that exist between the Statement and the various relevant legal requirements do not go to the core of the principles and, therefore, do not prevent them being a valuable aid to the standard-setting process.

On the other hand, legal frameworks change in response to developments in accounting thought, and framework documents such as the Statement are one of the things that help provide direction to such change. Therefore, if the Statement had been developed within the legal constraints, it would have been denied the opportunity to fulfil that role. The ASB thought that would be undesirable.

Appendix I of the Statement deals with this issue in greater detail and highlights the main inconsistencies between the Statement and the accounting requirements in companies legislation.

6 How far does the Statement fit into the growing movement towards the international harmonisation of accounting practices?

The Statement is based on the International Accounting Standards Committee's 'Framework for the Preparation and Presentation of Financial Statements' and, as Appendix II of the Statement—which compares the Statement with the IASC Framework—shows, there are few differences of significance between the two documents. The Statement is also largely consistent with the framework statements issued in Australia, Canada, New Zealand, the USA and elsewhere. This reflects the ASB's view that it will be easier to achieve harmonisation of accounting practice if standard-setters work with a common set of principles.

The focus on assets and liabilities and the role of transactions

7 The Statement places great emphasis on assets and liabilities and even defines the items to be included in the profit and loss account in terms of assets and liabilities. Does that mean the ASB regards the balance sheet as more important than the profit and loss account?

No it does not. The ASB recognises that the main focus of users is on financial performance—and, therefore, on the profit and loss account and other performance statements—and it has made it clear that it sees no reason to try to change that focus.

One of the things that the ASB has sought to do in the Statement of Principles is to set out a framework that can be used to determine which items should appear in which primary financial statement—in other words, a framework to be used to provide an answer to questions such as “should this item of expenditure be reported in the current period’s profit and loss account or the balance sheet?” For the reasons set out in Appendix III of the Statement, it has chosen to do that by providing robust unambiguous definitions of the items that are to be reported in the balance sheet. It has also made it clear that expenditure that is not to be reported in the balance sheet will need to be reported in the profit and loss account or other performance statement. The emphasis on assets and liabilities is therefore merely a means of improving the quality of financial statements in general and, through the discipline that the definitions will impose on the recognition of gains and losses, the profit and loss account in particular.

8 If the focus is now on assets and liabilities, will the role that transactions have in financial reporting change?

Since the accruals basis of accounting became commonplace, the main focus of the accounting process has been on allocating the effects of transactions between reporting periods. As a result, the primary source of the information provided in financial statements is the transactions undertaken by the reporting entity. The ASB sees no reason for that to change, as the Statement, through its definitions of elements and recognition criteria, is asking exactly the same questions that accruals accounting has always asked: what are the effects of the transaction and in which period should they be reported?

The Statement envisages that the financial statements will reflect *some* events that do not relate to transactions, but financial statements already do that. For example, events causing the recoverable amount of an item of stock to fall below its cost are reflected in the amount at which that stock is carried in the balance sheet.

9 Does the ASB regard the difference between the opening and closing balance sheets, adjusted for capital contributions and distributions, as the profit (or loss) for the period?

Under the approach adopted in the Statement, the difference between the two balance sheets that has not arisen from transactions with owners *is* equal to the total of all the components of financial performance, but it would be a gross oversimplification to suggest that the amount is therefore regarded as the profit or loss for the period. Indeed, the Statement does not recognise any particular figure as the profit or loss for the period, taking the view that there is no ‘magic’ in any total in the profit and loss account or statement of total recognised gains and losses. It therefore envisages that the focus of performance reporting will be on the components of financial performance and on the characteristics of those components. Indeed, that is the approach to performance reporting that has been adopted in the UK and the Republic of Ireland since FRS 3 ‘Reporting Financial Performance’ was issued in 1992.

10 What does the Statement say about the use of current values?

The Statement explains that historical cost and current value are alternative measures and that it is envisaged that entities will use the approach now adopted by the majority of the larger UK listed companies, in which some categories of balance sheet items are carried at historical cost and others at current value. The Statement also describes a framework to guide the choice of an appropriate measurement basis for each balance sheet category.

The Statement says nothing about the desirability or otherwise of adopting an approach that involves all balance sheet items being measured at current value, just as it says nothing about the desirability or otherwise of adopting an approach that involves all balance sheet items being measured at historical cost. All it does say is that both these approaches would involve a radical change to existing practice.

The implications for existing practice

11 Will accounting standards based on the Statement of Principles be very different from past accounting standards?

The ASB has been working with what are now the main principles set out in the Statement since the ASB's inception in 1990; all the standards that have been issued since then are therefore based on those principles. Indeed, some of the principles play very significant roles in those standards. For example:

- FRS 2 'Accounting for Subsidiary Undertakings' uses the reporting entity concept described in Chapter 2 of the Statement.
- FRS 4 'Capital Instruments', FRS 5 'Reporting the Substance of Transactions', FRS 7 'Fair Values in Acquisition Accounting' and FRS 12 'Provisions, Contingent Liabilities and Contingent Assets' all use the definitions of assets and liabilities set out in Chapter 4;
- FRS 11 'Impairment of Fixed Assets and Goodwill' uses the recoverable amount notion described in Chapter 6; and
- FRS 3 'Reporting Financial Performance' draws on the principles of good presentation described in Chapter 7.

12 So how close is the Statement to existing practice?

It is probably true that, compared with existing practice, parts of the Statement sound unfamiliar. That is not surprising because the Statement is a description of fairly high level principles, not detailed accounting practice.

Putting that aside, the Statement actually bears quite a close resemblance to much of existing practice. It should do so, because that is what it was derived from. There are some differences, of course, as one would expect from a document that provides guidance to the standard-setting process—a process that is intended to result in changes to practice.

Perhaps the most noteworthy difference concerns the slightly more restricted role that the Statement gives to the notion of matching. The effect of this is that items of expenditure and losses that, though not having economic benefits still to be derived from them, might be carried forward on the balance sheet under existing practice would, under the model described in the Statement, be recognised as losses in the profit and loss account.

The ASB does not believe that differences between the Statement and existing practice are a cause for concern. The standards published to date have been based on the principles in the Statement and have found general acceptance, and there is no reason to believe that this will change.

PART 3—BRIEF OVERVIEW OF THE STATEMENT OF PRINCIPLES

Introduction

1 The Statement of Principles for Financial Reporting sets out the principles that the ASB believes should underlie the preparation and presentation of financial statements that are required to give a true and fair view. Its primary focus is therefore on full annual financial statements.

2 The Statement's principles will also be applicable to financial statements contained in the interim reports, preliminary announcements and summary financial statements of listed UK companies, although additional considerations may be relevant in the context of those statements.

Chapter 1—The objective of financial statements

3 The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.

4 The objective of financial statements can usually be met by focusing exclusively on the needs of present and potential investors. Such investors need information about financial performance and financial position that is useful to them in evaluating the reporting entity's ability to generate cash and in assessing the entity's financial adaptability.

5 Financial statements do not provide *all* the information needed by users; they do, however, provide a frame of reference against which users can evaluate the more specific information they obtain from other sources.

Chapter 2—The reporting entity

6 Financial statements report on all the activities and resources under the control of the entity that has prepared them.

- Single entity financial statements (also known as individual entity financial statements) report on the activities and resources under the entity's direct control. The (non-consolidated) financial statements of a company are an example of such financial statements. In that example, the company is the reporting entity.
- Consolidated financial statements report on the activities and resources under the entity's direct and indirect control; in other words, on its own activities, assets and liabilities and also on the activities, assets and liabilities of its subsidiaries. For the purposes of consolidated financial statements, the group comprising the parent and its subsidiaries is the reporting entity.

Chapter 3—The qualitative characteristics of financial information

7 In deciding what information should be included in financial statements, when it should be included and how it should be presented, the aim is to ensure that financial statements yield useful information. Financial information is useful if it is:

- **relevant**—in other words, if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions.
- **reliable**—in other words, if:
 - it can be depended upon to represent faithfully what it either purports to represent or could reasonably be expected to represent, and therefore reflects the substance of the transactions and other events that have taken place;
 - it is complete and is free from deliberate or systematic bias and material error; and
 - in its preparation under conditions of uncertainty, a degree of caution has been applied in exercising the necessary judgements.
- **comparable**—in other words, if it enables users to discern and evaluate similarities in, and differences between, the nature and effects of transactions and other events over time and across different reporting entities.
- **understandable**—in other words, if its significance can be perceived by users that have a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided.

8 If a conflict arises between these characteristics, a trade-off needs to be found that still enables the objective of financial statements to be met. For example, if the information that is the most relevant is not the most reliable and vice versa, it will usually be appropriate to use the item of information that is the most relevant of those that are reliable.

9 The characteristics described in paragraph 7 are used to make decisions that will result in the usefulness of the financial information being maximised. The **materiality** test is then used to determine whether the information's usefulness is of such significance as to require it to be given in the financial statements. An item of information is material to the financial statements if its misstatement or omission might reasonably be expected to influence the economic decisions of users of those financial statements.

Chapter 4—The elements of financial statements

10 Financial statements need to reflect the effects of transactions and other events on the reporting entity's financial performance and financial position. This involves a high degree of classification and aggregation. Order is imposed on this process by specifying and defining the classes of items—the elements—that encapsulate the key aspects of the effects of those transactions and other events. The main elements and their definitions are as follows:

- **assets**—rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.
- **liabilities**—obligations to transfer economic benefits as a result of past transactions or events.
- **ownership interest**—the residual amount found by deducting all of the entity's liabilities from all of the entity's assets.
- **gains**—increases in ownership interest not resulting from transfers from owners in their capacity as owners.
- **losses**—decreases in ownership interest not resulting from transfers to owners in their capacity as owners.

11 The only elements to be included in the profit and loss account (and any other statement of financial performance, such as the statement of total recognised gains and losses) are gains and losses—terms that are intended to incorporate items that are more commonly referred to as ‘revenue’ and ‘expenses’. The only elements to be included in the balance sheet (or other statement of financial position) are assets, liabilities and ownership interest.

Chapter 5—Recognition in financial statements

12 The objective of financial statements is achieved to a large extent through depicting in the primary financial statements, in words and by a monetary amount, the effects that transactions and other events have on the elements. This process is known as **recognition**.

13 For example, if the effect of a transaction is to create a new asset or liability or to add to an existing asset or liability, that new asset or liability or addition will be recognised in the balance sheet if there is sufficient evidence that it exists and it can be measured reliably enough at a monetary amount. A gain or loss will be recognised at the same time, unless there has been no change in the total net assets or the whole of the change is the result of capital contributions or distributions.

14 Sometimes it is easier to identify the appropriate point at which to recognise a gain arising from the provision of services or goods by focusing on the operating cycle of the reporting entity. The critical event in that cycle is the point at which there will be sufficient evidence that the gain exists and that a reliable measure of the gain can be determined.

15 After being recognised for the first time, an asset (or liability) will usually continue to be recognised until it has been consumed, transferred or otherwise disposed of, or it expires (or, in the case of a liability, until it has been settled, extinguished, transferred or the obligation involved expires). At that point it will cease to be recognised—in other words, it will be **derecognised**.

16 Although it is usually relatively simple to determine whether and when a previously recognised asset (or liability) should be derecognised, some transactions or events eliminate some of the rights that underlie an asset (or some of the obligations that underlie a liability) while leaving other rights (or obligations) intact. In such circumstances, it may be necessary to derecognise part of the asset (or liability). In other cases, it may be necessary to derecognise the asset (or liability) completely and recognise in its place a new asset (or liability).

Chapter 6—Measurement in financial statements

17 In order that an asset or liability can be recognised, it needs to be assigned a monetary carrying amount. The Statement describes the two measurement bases that it envisages could be used for this purpose:

- **historical cost**, by which the Statement means lower of cost and recoverable amount; or
- **current value**, by which the Statement means lower of replacement cost and recoverable amount.

18 Most assets and liabilities arise from arm’s length transactions. In such circumstances and regardless of the measurement basis used, the carrying amount assigned on initial recognition will be the transaction cost.

19 The carrying amounts derived from the two bases will usually diverge after initial recognition, making it necessary to decide which basis to use. The Statement envisages the adoption of an approach—used by the majority of large UK listed companies—that

involves measuring some balance sheet categories at historical cost and some at current value. Although this is often referred to as the modified historical cost basis, it is more accurately referred to as the **mixed measurement system**.

20 The Statement envisages that the measurement basis used for a category of assets or liabilities will be determined by reference to factors such as the objective of financial statements, the nature of the assets or liabilities concerned and the particular circumstances involved. It also envisages that a separate decision as to the appropriate measurement basis will be taken for each balance sheet category. That decision will need to be kept under review as accounting thought, access to markets, and circumstances change.

21 Whatever the measurement basis chosen, the carrying amount may need to be changed from time to time. This process is known as **remeasurement**.

- When a historical cost measure is used, remeasurements are necessary to ensure that assets are stated at the lower of cost and recoverable amount and monetary items denominated in a foreign currency are stated at amounts based on up-to-date exchange rates.
- When a current value measure is used, remeasurements are necessary to ensure that items are stated at up-to-date current value.

22 Remeasurements will be recognised only if there is sufficient evidence that the monetary amount has changed and the new amount can be measured with sufficient reliability.

Chapter 7—Presentation of financial information

23 In presenting information in financial statements, the objective is to communicate clearly and effectively. Financial statements should be as simple, straightforward and brief as is possible while retaining their relevance and reliability. Good presentation avoids adding a mass of material and unnecessarily lengthening the statements.

24 The presentation of information in financial statements involves a high degree of interpretation, simplification, abstraction and aggregation. Although this means there will be a loss of detail, if it is done in an orderly manner the users of financial statements will benefit and greater knowledge and understanding will be created at all levels.

25 To this end, the presentation of financial performance information should focus on the components of that performance and on the characteristics of those components, including, for example, their nature, cause, function, relative continuity or recurrence, stability, risk, predictability and reliability. Although all components are relevant to an assessment of financial performance, their individual characteristics mean that some will carry more weight in some assessments—and in the assessment of some entities—than others.

26 The presentation of information on financial position should focus on the types and amounts of assets and liabilities held and the relationships between them, and on the function of the various assets.

27 The cash flow information should be presented in a way that distinguishes between those cash flows that result from operations and those that result from other activities. It should also show the extent to which the entity's various activities generate and use cash.

Chapter 8—Accounting for interests in other entities

28 Interests in other entities can have an important effect on the reporting entity's own financial performance and financial position. They therefore need to be fully reflected in the financial statements. How this is done will depend on:

- whether single entity financial statements or consolidated financial statements are being prepared;
- the degree of influence, if any, exerted over the activities and resources of the other entity and the nature of that interest.

29 In single entity financial statements, an interest in another entity is treated like any other asset. In consolidated financial statements:

- an interest that involves **control** of that other entity's operating and financial policies is dealt with by making the controlled entity part of the reporting entity itself;
- an interest that involves **joint control** of, or **significant influence** over, that other entity's operating and financial policies is dealt with by recognising the reporting entity's share of that other entity's results and resources in the financial statements in a way that does not involve showing them as if they were controlled by the reporting entity; and
- an interest that involves **lesser or no influence** over that other entity's operating and financial policies is dealt with in the same way as any other asset.

30 An amalgamation of two or more reporting entities will be accounted for in accordance with its character. All amalgamations can be characterised as either a purchase (or **acquisition**) or a uniting of interests (or **merger**).