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RECOGNITION OF ELEMENTS OF FINANCIAL STATEMENTS

National Organization for Financial Accounting and Reporting Standards
Russia

Content

Introduction

Russia fully adopted the IFRS in the year 2011, with mandatory effect for companies of a public interest starting from the reporting year 2012. And it is highly topical for Russian professional community to provide its relevant feed-back and to participate in the standard-setting process.

Russia, as other emerging economies, starts to face specific issues and gather practical experience on implementation of IFRS, in which relation we would like to share our views, to seek advice and probably relevant response from the IASB.

In particular, we call for uniform understanding and implementation of IFRS principles and requirements. But at the same time there is a lack of consistency in current practice, caused by the following reasons:

- there is a high influence of traditional accounting practices,
- not all items of financial statements are covered by the scope of existing Standards and Interpretations,
- some Standards and Interpretations reflect different accounting approaches because they were elaborated in different periods in the past,
- some Standards and Interpretations contradict to the current Conceptual Framework.
- according to the IAS 8, companies can use the other standards, based on similar Conceptual Framework.

As the important and basic point for further improvements of IFRSs we propose to address the issues of recognition principles of elements of financial statements and to consider the arguments disclosed below.

1. Implementation of accrual accounting

The effective adoption of IFRSs worldwide (including emerging economies) requires firm and uniform understanding of recognition principles of elements of financial statements (assets, liabilities, equity, income and expenses).

But the practice of IFRS implementation demonstrates that there are inconsistencies in approaches to recognition of elements of financial statements that is mainly caused by common misunderstanding of difference between matching principle and accrual basis.

According to the Conceptual Framework:

– accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur (p. OB17);

– recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (p. 4.47);

– recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (p. 4.49);

– application of the matching concept under this Conceptual Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities (4.50).

At the same time in practice the application of matching concept often prevails over principles of accrual accounting set in the Conceptual Framework. Furthermore there are some Standards that require deferring income and expenses.

In the Discussion Paper "A Review of the Conceptual Framework for Financial Reporting" the proposed improvements mostly address recognition of assets and liabilities, but the questions of recognition of income and expenses rest out of focus.

In this connection the following issues need further clarification and should be discussed:

- relevance of recognition of deferred expenses;
- relevance of recognition of deferred income;
- relevance of recognition of accrued liabilities;
- general correspondence of recognition criteria of assets, liabilities and income, expenses.

1.1. Recognition of deferred charges and prepaid expenses

Obviously, the practice of recognition of deferred charges and prepaid expenses has its origin in the "matching principle". And still now companies continue to include these items in their financial statements.

There are some typical situations when the deferred charges (or prepaid expenses) are habitually recognised:

- payments for insurance that covers future periods,
- payments for maintenance services that cover future periods,
- subscriptions for other services that cover future periods.

But there is also a specific situation when the existing IFRSs require recognising deferred charges:

- according to IAS 17 (p. 61) in a leaseback transaction resulting in an operating lease a loss that will be compensated for by future lease payments at below market price should be deferred and amortised.

In the view of the accrual accounting and in order to keep consistency in IFRS application it is necessary to clarify the following:

- whether such items as deferred charges and prepaid expenses could be recognised;
- in what circumstances deferred charges and prepaid expenses can meet the definition and recognition criteria of an asset;
- whether it would be correct and relevant to continue to use the definitions “deferred charges” and “prepaid expenses” in the IFRS financial statements, even if the definition and recognition criteria of an asset are met.

Preliminary views:

- the nature of practically all exiting items of deferred charges and prepaid expenses consists either in prepayments for future services, or in compensations receivable;
- in both cases (prepayments for future services and compensation receivable) these items can meet the definition and standard recognition criteria of an asset;
- it is neither relevant nor correct to continue to use the definitions “deferred charges” and “prepayment expenses”. Instead, these items should be classified as prepayments for services or compensations receivable (as relevant).

The guidance on these issues can be included in corresponding IFRSs. But taking into consideration the wide spread of possible practical circumstances (that could not be within the scope of a specific Standard) it is valuable to include the clarification of accounting approach to deferred charges and prepaid expenses at the level of the Conceptual Framework.

1.2. Recognition of deferred incomes

The practice of recognition of deferred income (or revenue) also derives from the “matching principle” And such items are still in use by now.

The examples of typical situations when the deferred income (or revenue) are habitually recognised are the following:

- proceeds for maintenance services that cover future periods,
- proceeds for subscriptions and other services that cover future periods.

There are also some specific situations when the existing IFRSs require recognition of deferred income:

- according to IAS 17 (p. 59) in a leaseback transaction resulting in an financial lease an excess of sales proceeds over the carrying amount shall not be immediately recognised as income by a seller-lessee. Instead, it shall be deferred and amortised;
- according to IAS 20 (p. 24) one method of accounting for government grants related to assets is to present it in the statement of financial position by setting up the grant as deferred income.

As in previous paragraph based on the principles of accrual accounting and in order to keep consistency in IFRS application it is necessary to clarify the following issues:

- whether such items as deferred income (or revenue) could be recognised;
- in what circumstances deferred income can meet the definition and recognition criteria of a liability;
- whether a received compensation of future costs (conditional and unconditional) can meet the definition recognition criteria of a liability;
- is it correct and relevant to continue to use the definitions “deferred income (or revenue)” in the IFRS financial statements, even if the definition and recognition criteria of a liability are met;
- is it necessary to pay attention to the possibility to distribute to owners the proceeds designated as deferred income – for the purposes of recognition and disclosure in financial statements.

Preliminary views:

- the nature of most items of deferred income represents either revenue for future services received in advance or received compensation of future costs;
- in both cases these items (revenue for future services received in advance or received compensation of future costs) could be recognised only if they meet the definition and recognition criteria of a liability;
- received compensation of future costs could meet the definition and recognition criteria of a liability, only if it is conditional. Unconditional received compensation of future costs should be recognised in income immediately;
- it is neither relevant nor correct to continue to use the definitions “deferred income (or revenue)”. Instead, these items should be classified as: prepayments received, conditional compensation received, liabilities on government grants or other specific item of liability (as relevant);
- it is useful to additionally disclose the possibility to distribute to owners the proceeds related to future periods.

As in previous paragraph the guidance on these issues can be included in corresponding IFRSs. But taking into consideration the wide spread of possible practical circumstances (that could not be within the scope of specific IFRSs) it is valuable to include the clarification of accounting approach to deferred income (or revenue) at the level of the Conceptual Framework.

1.3. Recognition of accrued liabilities for future services

In some circumstances blindfold following to the “matching principle” has resulted in recognition of accrued liabilities even if they do not really meet the definition and recognition criteria of liabilities. Although these accounting practices contradict to existing IFRSs and Conceptual Framework, they remain durable.

In particular, there is a quite common practice of recognition of accrued liabilities (or sometimes provisions) for future services. So companies often recognise accrued liabilities (or provisions) to the whole of contractual cost of services even if they are not rendered as of the end of reporting year, but considered as “related” to the reporting year. (Audit services can be cited as good example of this case).

Typical conditions of this situation could be summarized as follows:

- the services are not yet fulfilled or partly fulfilled an the end of reporting year;
- the contract in not binding, cancellable without penalties and there is no obligation to pay for services that are not yet rendered;
- reporting entity plans and even has economic compulsion to pay for these services;
- as of the date of signing of the financial statement the services are fulfilled and their costs are known.

Preliminary views:

- the practice of recognition of accrued liabilities (or provisions) for future services contradicts to the existing IFRSs and Conceptual Framework;
- in the above mentioned conditions as of the end of reporting year there is no present obligation to pay the whole of contractual costs of services (but only for a rendered part if such condition is provided in the contract);
- if the contract is not binding, a present obligation appears only if the services are fulfilled as of the end of reporting year;
- the existence of plans or economic compulsion to pay for these services does not cause the existence of present obligation.

A guidance clarifying this issue can be included in the Conceptual Framework. In order to stop this incorrect practice it would be also useful to attract additional attention to it by the means that the IASB will count relevant.

1.4. General correspondence of recognition criteria

According to the current Conceptual Framework, 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, income or a liability (p. 4.39).

At the same time the practice of IFRS implementations shows that this principle in not clearly understood. Furthermore there are Standards that set different recognition criteria of assets and income (for example: accounts receivables and revenue).

Preliminary views:

- it seemed useful to set in the Conceptual Framework an unambitious principle that recognition of income and expenses should be resulted from recognition and derecognition of assets and liabilities, as well as that Standards or Interpretations should not set specific recognition criteria for income and expenses;
- existing IFRSs should be reviewed in order to exclude specific recognition criteria for income and expenses.

2. Further changes in Conceptual Framework

In relation to issues of recognition of elements we should mention that Discussion Paper "A Review of the Conceptual Framework for Financial Reporting" addresses many important points among which we would like to attract attention to the following.

2.1. Definition of economic resource

In the Discussion Paper it is proposed to set a definition of economic resource as "a right, or other source of value, that is capable of producing economic benefits" and to provide additionally a list of possible forms that the economic resource may take.

Preliminary views:

- we strongly support the initiative to set a definition of economic resource and a list of possible types of economic resources, because this will help to identify and recognize different assets, even in absence of particular IFRSs that cover all types of assets;
- at the same time the process of identification, recognition and measurement of the assets (and liabilities) becomes more complicated and compounded of many steps (including for example: determining the existence of control, capability of producing economic benefits, deciding whether the item is relevant, could be faithfully represented, measured reliably etc.). That is why it would be very useful to provide additional educational or instructive guidance that describes all necessary steps to be taken during the whole process of identification, recognition and measurement of the assets (and liabilities).

2.2. Probability of future economic benefits

In the Discussion Paper it is proposed that uncertainty should not play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, and in particular that:

- the definitions of assets and liabilities should not retain the notion that an inflow or outflow is "expected". An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources;
- the Conceptual Framework should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability;
- the recognition criteria should not retain the existing reference to probability.

Preliminary views:

- the proposed construction of definitions of an asset, a liability and an economic resource generally structures and simplifies the logic of decision making in respect of assets and liabilities. At the same time there is a concern that some consequences of such a simplifying that may significantly impair or even annihilate benefits from it;
- due to various reasons, IFRSs are principally unable to prescribe accounting treatment for all existing and future transactions and events in business activities. Therefore, it will always be necessary to develop accounting policies in the absence of specific requirements. In such cases, the proposed definition of an asset and a liability may lead to uncontrolled enhancing of items recognised as assets and liabilities in financial statements prepared in accordance with the IFRSs. That, on the one hand, will increase both complexity and costs of preparing such financial statements with uncertain benefits from it and, on the other hand, create broadened facilities for manipulating of financial reporting information;
- the removal of the probability threshold is not beneficial and, if implemented, will give rise to tremendous practical issues and will ultimately force the IASB to introduce multiple departures from the framework into its standards. In other words, such framework, even if conceptually crisp, may not be possible to implement in practice, or it will result in an inconsistent set of standards - which would be no improvement from the current situation;
- the IASB should continue its deliberations in the area of the definitions of assets and liabilities.