IFRS Accounting

Educational Module 2
Concepts and Pervasive Principles

IFRS for SMEs®

Accounting Standard

Third Edition

International Accounting Standards Board

IFRS® Foundation
Supporting Material for the
IFRS for SMEs® Accounting Standard

including the full text of
Section 2 *Concepts and Pervasive Principles*
of the *IFRS for SMEs* Accounting Standard issued by
the International Accounting Standards Board in February 2025

with extensive explanations and self-assessment questions

This document is not part of the *IFRS for SMEs* Accounting Standard or IFRS Accounting Standards and does not add to or otherwise change the requirements in the Standards. It was developed to aid stakeholders' understanding of our Standards. Views expressed in the document do not necessarily reflect those of the International Accounting Standards Board or the IFRS Foundation. The document should not be relied upon as professional or investment advice.

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The requirements in Section 2 *Concepts and Pervasive Principles* of the *IFRS for SMEs* Accounting Standard are set out in this module and shown with grey shading. Appendix B of the *IFRS for SMEs* Accounting Standard contains the glossary (Glossary) and is also part of the requirements. Terms defined in the Glossary are reproduced in **bold type** the first time they appear in the text of Section 2.

This module has been prepared by the International Accounting Standards Board (IASB) technical staff. The educational notes and examples inserted by the staff are not shaded. These educational notes and examples do not form part of the *IFRS for SMEs* Accounting Standard and have not been approved by the IASB.

INTRODUCTION

The *IFRS for SMEs*® Accounting Standard

The *IFRS for SMEs* Accounting Standard (Standard) is intended for use by small and medium-sized entities that publish general purpose financial statements and that do not have public accountability (referred to as small and medium-sized entities—see Section 1 *Small and Medium-sized Entities*).

The objective of general purpose financial statements is to provide financial information about a reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

More information about the Standard and its supporting materials is available on the IFRS Foundation website: www.ifrs.org.

This module

This module focuses on the concepts that underlie financial statements prepared in accordance with the *IFRS for SMEs* Accounting Standard. The concepts in Section 2 are based on the IASB's *Conceptual Framework for Financial Reporting* (issued in 2018) (2018 *Conceptual Framework*). Some of the education notes in this module are derived from the Basis for Conclusions on the 2018 *Conceptual Framework*. References to the 2018 *Conceptual Framework* are not meant to imply that users of the Standard should be familiar with the 2018 *Conceptual Framework*.

The module introduces the subject and reproduces the official text along with explanatory notes and examples designed to enhance understanding of the requirements. It identifies the significant judgements required when considering the concepts and pervasive principles underpinning the Standard and includes questions designed to test your understanding of these concepts and pervasive principles.

After completing the module, you should be able to:

- understand the objective of general purpose financial statements of a small or medium-sized entity;
- understand how an entity uses judgement in developing and applying an accounting policy that results in information that both faithfully represents the underlying transactions and is relevant to the economic decision-making needs of users of SMEs' financial statements when there are no specific requirements elsewhere in the Standard;

- understand fundamental and enhancing qualitative characteristics that make information provided in financial statements useful to users of those financial statements;
- identify the elements of financial statements and their pervasive recognition and measurement principles;
- understand how to apply the undue cost or effort exemption; and
- understand the general principle setting out when offsetting is required or permitted.

Which version of the Standard does the module refer to?

Any reference in this module to 'the *IFRS for SMEs* Accounting Standard' is to the third edition of the Standard, issued in February 2025.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors when making decisions related to providing resources to the entity.

The concepts and pervasive principles are intended primarily:

- to assist preparers to develop consistent accounting policies when no section of the Standard applies to a particular transaction or the relevant section does not provide requirements for such a transaction; and
- to assist all parties to understand and apply the Standard.

The concepts in Section 2 that support the objective of general purpose financial statements are the qualitative characteristics of information in financial statements and the elements of the financial statements (described below). Section 2 also provides principles for the recognition, measurement and presentation of the elements of financial statements.

When the Standard does not specifically address a transaction, other event or condition, an entity's management uses judgement in developing and applying an accounting policy that results in information that is both reliable and relevant to the economic decision-making needs of users. If, in making these judgements, management cannot use the requirements and guidance in the Standard setting out similar and related issues, then it must consider the pervasive principles in Section 2 (see paragraphs 10.4 and 10.5 of Section 10 *Accounting Policies, Estimates and Errors*) as well as considering definitions of the elements of financial statements, recognition criteria and measurement concepts.

What has changed in the third edition of the Standard?

For the third edition of the Standard, Section 2 has been rewritten to align with the 2018 *Conceptual Framework*. The main differences from the 2018 *Conceptual Framework* are outlined at the end of this module and the language used in Section 2 has been simplified for ease of use.

REQUIREMENTS AND EXAMPLES

Scope of this section

2.1 This section describes the **objective of financial statements** of **small and medium-sized entities** (SMEs). It also sets out the concepts and basic principles underlying the **financial statements** of SMEs.

2.2 The concepts and principles in this section might not always align with the requirements in other sections of the Standard. In those cases, the requirements in the other sections take precedence over the concepts and principles in this section.

Educational notes

By articulating the objective of and the principles and concepts underlying SMEs' financial statements, and by identifying the qualities that make the information in those financial statements useful, Section 2 serves two important functions. It assists:

(a) preparers in developing consistent accounting policies when no requirement in the Standard applies to a particular transaction or other event or condition; and

(b) all parties in understanding and interpreting the Standard.

In accordance with paragraph 10.4, when the Standard does not specifically address a transaction, other event or condition, an entity must select an accounting policy that results in relevant and reliable information. Paragraph 10.5 directs that, in making that judgement, an entity first consider the requirements and guidance in the Standard dealing with similar and related issues. Next, the entity is directed to consider definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses, as well as considering the pervasive principles in Section 2. If the Standard does not provide specific requirements, paragraph 10.6 of the Standard allows the entity to look to the requirements in full IFRS Accounting Standards dealing with similar and related issues.

Paragraph 2.2 helps preparers to prioritise when developing accounting policies by telling them when to use the requirements in Section 2 and what to do if these requirements give a different outcome from that arising from applying other parts of the Standard. The 2018 *Conceptual Framework* stands separately from full IFRS Accounting Standards; in the Standard, however, Section 2 has the same status as all the other sections, so it is necessary to specify which requirements take precedence.

Example—Other sections taking precedence

Ex 1 **An SME has acquired a new subsidiary and recognises goodwill in its consolidated statement of financial position. The SME is considering treating the goodwill as having an indefinite useful life and therefore not amortising the intangible asset. Management believes that this satisfies the principle of faithful representation because the acquired subsidiary is expected to continue providing benefits to the group.**

Section 18 *Intangible Assets other than Goodwill* requires that all intangible assets are considered to have a finite useful life. Management's proposed approach is therefore not permissible.

Objective, usefulness and limitations of general purpose financial statements

2.3 The objective of an entity's **general purpose financial statements** is to provide financial information about the **reporting entity** that is useful to existing and potential investors, lenders and other creditors when making decisions related to providing resources to the entity.[1]

2.4 Useful information about a reporting entity includes information about:

(a) the **economic resources** of the entity, claims against the entity and changes in those resources and claims; and

(b) how efficiently and effectively the entity's management has met its responsibilities to use the entity's economic resources.

2.5 However, general purpose financial statements do not and cannot provide all the information that existing and potential investors, lenders and other creditors consider when making decisions. These users of an entity's general purpose financial statements (users) also consider pertinent information from other sources—for example, general economic conditions and expectations, political events, and industry and company outlooks.[2]

Educational notes

Section 2 identifies the users of SMEs' financial statements, and paragraph BCZ15 of the Basis for Conclusions on the *IFRS for SMEs* Accounting Standard states that the main groups of external users include:

(a) banks that make loans to SMEs;

(b) vendors that sell to SMEs and use SMEs' financial statements to make credit and pricing decisions;

(c) credit rating agencies and others that use SMEs' financial statements to rate SMEs;

1 Throughout this section, 'financial statements' refers to general purpose financial statements unless specified otherwise.

2 Throughout this section, 'users' refers to existing and potential investors, lenders and other creditors who rely on general purpose financial statements for much of the financial information they need (primary users of general purpose financial statements).

(d) customers of SMEs that use SMEs' financial statements to decide whether to do business; and

(e) SMEs' shareholders that are not also managers of their SMEs.

Each of these groups of users will make different decisions regarding an SME. However, the aim of these decisions is often to assess the amount, timing and uncertainty of the SME's future cash flows and management's stewardship of the SME's economic resources.

In establishing standards for the form and content of general purpose financial statements, the needs of users of financial statements are paramount. Users of SMEs' financial statements might have more interest in some information in general purpose financial statements prepared in accordance with full IFRS Accounting Standards than in other information. For example, users of SMEs' financial statements might have greater interest in information that tells them about short-term cash flows, liquidity and the strength of the statement of financial position, or in the historical trends of profit or loss and interest coverage, than they do in information that is intended to help make forecasts of an entity's long-term results and cash flows. This assessment of priorities is also reflected in the way the IASB chose which disclosure requirements to include in the Standard.

Users of financial reports prepared in accordance with full IFRS Accounting Standards or the *IFRS for SMEs* Accounting Standard have similar information needs from financial statements, irrespective of the type of entity. In developing the *IFRS for SMEs* Accounting Standard by making simplifications to full IFRS Accounting Standards, the IASB acknowledges that differences in the types and needs of users of SMEs' financial statements, as well as limitations in, and the cost of, the accounting expertise available to SMEs, suggest that a separate standard for SMEs is appropriate.

Information about a reporting entity's economic resources, claims against the entity and changes in resources and claims

2.6 General purpose financial statements provide information about an entity's financial position, specifically about the entity's economic resources and the claims against the entity. Financial statements also provide information about the effects of transactions and other events that change the entity's economic resources and claims. Users use this information to make decisions and form expectations based on their assessment of the amount, timing and uncertainty of the entity's future **cash flows**.

2.7 Financial statements also show how efficiently and effectively the reporting entity's management has met its responsibility to use the entity's economic resources. This information helps users assess management's stewardship of those resources.

Educational notes

Users make resource allocation decisions as well as decisions on how efficiently and effectively the reporting entity has used its economic resources. These assessments enable users of financial statements to hold management to account for its actions. Information designed for resource allocation decisions is also often useful for assessing management's performance.

Qualitative characteristics of information in financial statements

2.8 An entity uses the qualitative characteristics of useful financial information described in paragraphs 2.9–2.24 to identify the types of information likely to be most useful for users when making decisions about the entity.

2.9 Financial information is useful only if it is relevant and faithfully represents what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

Educational notes

The qualitative characteristics of information in financial statements help with identifying the types of information that are useful to users for making decisions about the reporting entity.

Using the qualitative characteristics for this purpose is an iterative process that follows no prescribed order. Sometimes, one enhancing qualitative characteristic might have to be diminished to maximise another. For example, a temporary reduction in comparability as a result of prospectively applying an amendment to the Standard might be worthwhile to improve the relevance or reliability of information in the longer term. Appropriate disclosures might partially compensate for the inability of users to compare information in some instances.

Fundamental qualitative characteristics

2.10 The **fundamental qualitative characteristics** of financial information are relevance and faithful representation.

Relevance

2.11 Financial information is relevant if it can influence users' decisions. Information might be relevant even if some users choose not to make use of it or are already aware of it from other sources.

2.12 Financial information can affect users' decisions by having predictive value, confirmatory value or both.

Educational notes

It is self-evident that financial information is useful for decision-making only if it is capable of influencing a decision by users of financial statements. Relevance is the term used to describe that capability. Many decisions by investors, potential investors, lenders and other creditors are based on implicit or explicit predictions about the amount and timing of the return on an equity investment, loan or other credit instrument. Consequently, information is capable of influencing one of those decisions only if it will help users to make new predictions (predictive value), help users to confirm or correct prior predictions (confirmatory value), or both. Information has predictive value if it can be used in making predictions about the eventual outcomes of past or current events.

The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value. For example, revenue information for the current year, which can be used as the basis for predicting revenue in future years, can also be compared with current-year revenue predictions made in past years. The results of those comparisons can help a user to correct and improve the processes used to make those previous predictions.

Information that is 'boiler plate', that is, standardised text that is generic in nature and applies to many entities, might not be relevant. This also includes policy statements that are irrelevant to understanding the entity's financial statements. An example might be a description of an accounting policy for impairment of intangible assets when the entity has no such assets in the current or previous period.

Materiality

2.13 Information is **material** if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the **primary users** of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity. Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of the entity's financial statements. Consequently, the IASB cannot specify a uniform quantitative threshold for materiality or predetermine what information might be material in a particular situation.

Educational notes

Materiality is an aspect of relevance, because immaterial information does not affect a user's decision-making. Financial statement users are assumed to have a reasonable knowledge of business, economic activities and accounting and a willingness to study financial information with reasonable diligence.

Because information can be material due to its nature or its magnitude, the IASB cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a given situation. The assessment of materiality is both quantitative and qualitative.

An entity need not apply its accounting policies when the effect of not applying them is immaterial (see paragraph 10.3 of Section 10). This also means an entity need not provide a specific disclosure required by the Standard if the information is not material.

Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which forms line items in the financial statements. If an item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements might warrant separate disclosure in the notes.

The IASB issued Practice Statement 2 *Making Materiality Judgements* in 2017. It is a non-mandatory statement providing guidance on materiality, and although it was not written with SMEs as the target it might still provide useful guidance.

Example—Immaterial items

Ex 2 **In 20X9, after an SME's 20X8 financial statements were approved for issue, the SME discovered an error in the calculation of depreciation expense for the year ended 31 December 20X8. The error meant the SME's reported profit before tax for the year ended 31 December 20X8 of CU600,000 was understated by CU150.**[3]

The error is not material because it is highly unlikely that an error of this nature and magnitude could influence the economic decisions of users made on the basis of the financial statements. Hence, the SME would not need to apply the requirements for corrections to prior period errors set out in paragraph 10.21.

Examples—Material items

Ex 3 **The facts are the same as in Example 2. However, in this example, if the error had been corrected the SME would have breached a borrowing covenant on a significant long-term liability.**

The error is material because it could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements. Hence, the SME would need to apply the requirements for corrections to prior period errors set out in paragraph 10.21.

Ex 4 **In 20X9, before an SME's 20X8 financial statements were approved for issue, the SME discovered a systemic error in the calculation of its defined benefit obligation in respect of the employees' pension scheme. Further investigation revealed that the calculation had been incorrectly performed since the defined benefit plan was started in 20X0. The cumulative effect of the error on the retained earnings of the SME at the beginning of 20X8 is an overstatement of CU600,000. The SME reported total equity of CU950,000 at 31 December 20X7.**

The error is material because it could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements.

In examples 2–4, the SME's management assesses the size or nature of the items to which the information relates based on the entity's circumstances.

3 In this example, and in all other examples in this module, monetary amounts are denominated in currency units (CU).

Faithful representation

2.14 Financial statements represent economic phenomena in words and numbers. Useful financial information not only represents relevant phenomena, but also faithfully represents the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, information about the legal form would not, by itself, faithfully represent the economic phenomenon.

2.15 To be a perfectly faithful representation, a depiction of an economic phenomenon would have three characteristics: completeness, neutrality and freedom from **error**. Perfection is rarely, if ever, achievable. Instead, the IASB's objective is to maximise those qualities to the extent possible.

2.16 To be complete, a depiction of an economic phenomenon includes all information necessary for a user to understand the phenomenon, including all necessary descriptions and explanations.

2.17 To be neutral, a depiction of an economic phenomenon is without bias in the selection or presentation of financial information. Neutrality is supported by **prudence**, which is the exercise of caution when an entity makes judgements under conditions of uncertainty. The exercise of prudence means that **assets** and **income** are not overstated and **liabilities** and **expenses** are not understated. Equally, prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses. Such misstatements can lead to the overstatement or understatement of income or expenses in future periods. Consequently, some sections of this Standard might contain asymmetric requirements if necessary to help an entity select the most relevant information that faithfully represents what it purports to represent.

2.18 Faithful representation does not mean the depiction of an economic phenomenon is accurate in all respects. To be free from error, a depiction of the phenomenon contains no errors or omissions, and an entity has selected and applied, without errors, a process to produce the information in the financial statements.

Educational notes

A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all the assets in the group, and a description of what the numerical depiction represents (for example, historical cost or fair value). For some items, a complete depiction might also entail explanations of significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction.

Faithful representation does not mean 'accurate in all respects'. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate. In other words, reliability does not equal precision.

A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. As the Standard says, neutrality is supported by prudence, and neutrality also requires that entities do not apply 'too much' prudence, which could lead to excessive recognition of liabilities and understatement of profits.

A representation based on a legal form that differs from the economic substance of the underlying economic phenomenon might not be faithful. The legal form should generally be considered as persuasive evidence of the economic substance of an underlying phenomenon. However, there are circumstances in which this might not be the case. For some such phenomena, an entity might need to perform an in-depth review of facts and circumstances in arriving at a judgement that overrides the legal form.

Examples—Substance over form

Ex 5 **An SME that manufactures luxury yachts sells a yacht to a bank for CU1,000,000 and simultaneously enters into an agreement to repurchase the yacht from the bank for CU1,080,000 one year later.**

On the date of entering into the transaction, the fair value of the yacht was CU2,000,000 and the manufacturer's incremental borrowing rate approximated 8% per year.

The bank has no right to sell the yacht.

The yacht manufacturer must not recognise revenue from the sale of the yacht. The substance of the two transactions together is that the manufacturer has borrowed CU1,000,000 from the bank, which is secured by the manufacturer's yacht (inventory asset). Accordingly, the manufacturer must recognise the CU1,000,000 received from the bank as a secured liability and the yacht must remain in the manufacturer's inventory.

The CU80,000 (excess of the CU1,080,000 repurchase price over the CU1,000,000 selling price) is recognised as an expense (finance costs) over the period of the liability using the effective interest method.

Ex 6 **The facts are the same as in Example 5. However, in this example, the SME has an option (not an obligation) to repurchase the yacht from the bank for CU1,080,000 one year after the sale.**

Because the fair value of the yacht is significantly higher than the strike price of the option to repurchase the yacht, the SME is most unlikely to let the option lapse. Consequently, the substance of the two transactions together is still that the SME has borrowed CU1,000,000 from the bank, which is secured by the SME's yacht (inventory asset). Accordingly, the SME must recognise the CU1,000,000 received from the bank as a secured liability and the yacht must remain in the SME's inventory.

Applying the fundamental qualitative characteristics

2.19 The most efficient and effective process by which an entity applies the fundamental qualitative characteristics of financial information, subject to the effects of enhancing characteristics (see paragraph 2.20) and the cost constraint (see paragraphs 2.25–2.27), is usually:

(a) first, to identify an economic phenomenon, about which information can be useful to users.

(b) second, to identify the type of information about the phenomenon in (a) that would be most relevant.

(c) third, to assess whether the relevant information in (b) is available and whether it can provide a faithful representation of the economic phenomenon. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the entity repeats the process with the next most relevant type of information. In some cases, the entity might have to prioritise one or more of the fundamental qualitative characteristics over others to meet the objective of financial statements (see paragraph 2.32).

Educational notes

The qualitative characteristics of information in financial statements help with identifying the types of information that are useful to users for making decisions about the reporting entity. Information must both be relevant and provide a faithful representation of what it purports to represent if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions.

In some cases, a trade-off between the fundamental qualitative characteristics might need to be made to meet the objective of financial reporting, which is to provide useful information about economic phenomena. For example, the most relevant information about a phenomenon might be a highly uncertain estimate. In some cases, the level of measurement uncertainty involved in making that estimate may be so high that it is questionable whether the estimate would provide a sufficiently faithful representation of that phenomenon. In some such cases, the most useful information could be the highly uncertain estimate, accompanied by a description of the estimate and an explanation of the uncertainties that affect it. In other such cases, if that information would not provide a sufficiently faithful representation of that phenomenon, the most useful information might include an estimate of another type that is slightly less relevant but is subject to lower measurement uncertainty. In limited circumstances, there might be no estimate that provides useful information. In those limited circumstances, it may be necessary to provide information that does not rely on an estimate.

Enhancing qualitative characteristics

2.20 Comparability, verifiability, **timeliness** and **understandability** are qualitative characteristics that enhance the usefulness of relevant information that provides a faithful representation of what it purports to represent. These enhancing qualitative characteristics might also help an entity decide how it depicts an economic phenomenon if the entity judges that more than one way provides equally relevant information and an equally faithful representation of that phenomenon.

Educational notes

The enhancing qualitative characteristics might also help determine which of two ways should be used to depict a phenomenon if both are considered to provide equally relevant information and an equally faithful representation of that phenomenon.

Comparability

2.21 Information about an entity is more useful if users can compare that information with similar information about other entities and with similar information about the same entity for another period or another date. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences between, items. Comparability is reduced if entities are permitted to use alternative accounting methods for the same phenomenon.

Educational notes

Users' decisions involve choosing between alternatives, for example, extending credit to an entity or not. Consequently, information about an SME is more useful if it can be compared with similar information about other SMEs and with similar information about the same SME for another period or another date. Comparability is the qualitative characteristic that enables users to identify and understand similarities in and differences among items.

Consistency is related to, but not the same as, comparability. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

A faithful representation of a relevant economic phenomenon should naturally possess some degree of comparability with a faithful representation of a similar relevant economic phenomenon by another reporting entity.

An important implication of the qualitative characteristic of comparability is that users must be informed of the accounting policies that have been used to prepare the financial statements, any changes in those policies and the effects of such changes. Including the disclosure of the accounting policies used by the entity helps to achieve comparability.

Verifiability

2.22 Verifiability helps assure users that information faithfully represents the phenomenon it purports to represent. Verifiability means that knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is faithful. Quantified information does not have to be a single point estimate to be verifiable; a range of possible amounts and the related probabilities can also be verified.

Educational notes

Information can be verified directly (through observation) or indirectly (for instance through checking the inputs to a model). Some explanations and forward-looking information (see paragraphs 2.35–2.36 and the related educational notes) might not be verifiable at the time financial statements are prepared. In these situations, it would normally be necessary to disclose the underlying assumptions, the methods of compiling the information and other factors that support the information.

Timeliness

2.23 Timeliness means having information available to decision-makers in time for it to be able to influence their decisions. Generally, the older the information is, the less useful it is. However, some information might continue to be timely long after the end of a **reporting period** because, for example, some users will use it to identify and analyse trends.

Educational notes

Timeliness means making information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information might continue to be timely long after the end of a reporting period because, for example, some users might need to identify and assess trends.

Understandability

2.24 Classifying, characterising and presenting information clearly and concisely makes it understandable. However, understandability should not be used as a justification for omitting material information. A set of financial statements would be incomplete if an entity excluded information about phenomena because the phenomena are inherently complex and cannot be made easy to understand.

Educational notes

Classifying, characterising and presenting information clearly and concisely makes it understandable. Information that is difficult to understand should be presented and explained as clearly as possible.

It is assumed that users of SMEs' financial statements are well informed and diligent. Even so, there will be times when these users need an adviser to help them understand complex phenomena, so information in financial statements might not always be immediately understandable even if it is prepared well.

Examples—Understandability

Ex 7 An SME chooses not to account for deferred tax because its management believes that the users of its financial statements would not understand that financial information.

The SME cannot state compliance with the Standard if it chooses not to account for deferred tax in accordance with Section 29 *Income Tax* on the grounds that management believes the users of its financial statements would not understand that financial information.

Ex 8 An SME has investment property. Under tax legislation in the SME's jurisdiction, it is required to submit an annual certified estimate of the fair value of the property. However, its management believes that users of its financial statements will not understand the volatility of this information. Consequently, it chooses to use the undue cost or effort exemption in Section 16 *Investment Property* and does not account for the fair value of the property.

The SME cannot state compliance with the Standard if it chooses not to measure the investment property at fair value in accordance with Section 16, despite the fact that management believes the users of its financial statements would not understand that financial information. The local requirement to submit an annual certified estimate of fair value means that the SME incurs no additional cost by measuring the property at fair value, so the undue cost or effort exemption is not available.

The cost constraint on useful financial reporting

2.25 Cost is a pervasive constraint on the information that an entity can provide. Reporting financial information imposes costs on an entity, so it is important that those costs are justified by the benefits of reporting that information.

2.26 Entities expend most of the effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users also incur costs of analysing and interpreting the information an entity provides. If entities do not provide needed information, users incur additional costs to obtain that information elsewhere or to estimate it.

2.27 Reporting relevant financial information that faithfully represents what it purports to represent helps users to make decisions confidently. Confident decision-making results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual user also benefits by making more informed decisions. However, it is not possible for financial statements to provide all the information that every user might find relevant.

Educational notes

Cost is a pervasive constraint that the IASB keeps in mind when considering the benefits of a possible new financial reporting requirement because reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

Reporting financial information that reflects the substance of transactions and is understandable, relevant, material, reliable, prudent, complete and comparable helps users to make decisions with more confidence. Such confidence results in the more efficient functioning of the whole economy. An individual user also receives benefits by making more informed decisions. However, it is not possible for general purpose financial statements to provide all the information that every user finds relevant.

In developing the Standard, the IASB made simplifications from full IFRS Accounting Standards on the basis of users' needs and cost–benefit analyses for SMEs. In practice, the benefits of applying accounting standards differ across reporting entities, depending primarily on the information needs of the users of their financial statements.

Undue cost or effort

2.28 Some requirements in this Standard are accompanied by an undue cost or effort exemption. Such exemptions do not apply to other requirements in this Standard.

2.29 Whether an entity must spend undue cost or effort to obtain or judge the information necessary to comply with a requirement depends on the entity's specific circumstances and on management's judgement of the costs and benefits of applying that requirement. To make this judgement, an entity considers how users' decision-making could be affected by not having that information. An entity would spend undue cost or effort applying a requirement if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceeds the benefits users would receive from having the information. This Standard usually requires an SME to judge undue cost or effort using a lower threshold than other IFRS Accounting Standards require of publicly accountable entities because SMEs are not accountable to public stakeholders.

2.30 An entity judges whether a requirement would involve undue cost or effort on initial **recognition** in the financial statements—for example, at the date of the transaction—based on information about the costs and benefits of the requirement at the time of initial recognition. If the undue cost or effort exemption also applies after initial recognition—for example, to a subsequent measurement of an item—the entity makes a new judgement of undue cost or effort at that subsequent date, based on information available at that date.

2.31 If an entity applies an undue cost or effort exemption, the entity shall disclose that fact and the reasons why applying the requirement would involve undue cost or effort. This requirement does not apply to the undue cost or effort exemption in paragraph 19.16, which is covered by the disclosure requirements in paragraph 19.38.

Educational notes

Some exemptions from requirements in the Standard are effective when it would be impracticable to comply with a given requirement. For example, paragraph 3.12 requires that when an entity changes the presentation or classification of items in its financial statements, the entity reclassifies comparative amounts unless reclassification is impracticable. The Glossary explains that applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. An example of when reclassification might be impracticable could be when a fire has destroyed records such that the entity lacks the information to be able to reclassify items from an earlier year. The impracticability test is a high hurdle.

The undue cost or effort exemption is a lower hurdle than the impracticability exemption. The undue cost or effort exemption is a practical expedient that balances the cost of accounting for an item or disclosing a piece of information as required in a section with the benefits to be derived by users from that accounting or disclosure. An entity is required to carefully weigh the expected effects of applying the exemption on the users of its financial statements against the cost or effort of complying with the related requirement. If an entity already has, or could easily and inexpensively acquire, the information necessary to comply with a requirement, any undue cost or effort exemption that might otherwise have been applicable to that requirement would not be applicable. This is because, in that case, the benefits to the users of the financial statements of having the information would be expected to exceed any further cost or effort by the entity.

Applying an undue cost or effort exemption necessitates consideration of how users of the financial statements would be affected if that exemption is taken. Consequently, it might be easier for an SME to meet the undue cost or effort exemption than it would be for entities with public accountability, because the exemption is applied relative to the benefits to users of SMEs' financial statements.

The requirements within the Standard have been developed taking into consideration the balance between benefits and costs. The Standard also includes an undue cost or effort exemption only in defined circumstances; the undue cost or effort exemption is not available in other areas and can be used only if the Standard explicitly specifies that it can be applied to a requirement.

Sometimes the undue cost or effort exemption applies only at initial recognition, in which case the assessment is made once and not revisited. If, however, it applies to a recurring measurement, for instance the requirement in paragraph 11.14(c)(i) of the Standard to measure some investments at fair value through profit or loss, the use of the exemption will be revisited each period. Between years the entity might have found a way to measure an item more easily, or users might have developed a particularly pressing interest in the information, meaning the efforts of producing it become worthwhile.

Financial statements and the reporting entity

Objective and scope of financial statements

2.32 The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, **equity**, income and expenses that is useful to users to assess the prospects for the entity's future net cash inflows and management's stewardship of the entity's economic resources (see paragraph 2.4).

Educational notes

Financial statements provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. This information is useful input for decisions about providing resources to an entity.

Economic resources and claims

Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to assess the reporting entity's liquidity and solvency and its needs for additional financing, and this is of particular interest to users of SMEs' financial statements. Such information can also help users assess how successful the entity is likely to be in obtaining financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with claims against the reporting entity.

A user's assessment of the reporting entity's estimated future cash flows differs for different economic resources. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial statements need to know the nature and amount of the resources available for use in a reporting entity's operations.

Reporting period

2.33 An entity prepares its financial statements for a specified reporting period and discloses information about:

(a) its assets and liabilities—including unrecognised assets and liabilities—and equity that existed at the end of or during the reporting period; and

(b) its income and expenses for the reporting period.

2.34 To help users identify and analyse changes and trends, an entity also discloses in its financial statements comparative information for at least one preceding reporting period, except if this Standard permits or requires otherwise.

Educational notes

The Standard does not specify what length a reporting period may be, nor does it place limits on changing the reporting date. These are usually matters for local law or regulation. However, the requirement for comparative information reminds preparers that comparability matters to users, and having a consistent reporting period that does not change length plays an important part in this comparability.

2.35 An entity also discloses in its financial statements information about possible future transactions and events if the information:

(a) relates to the entity's assets or liabilities—including unrecognised assets or liabilities—or to equity that existed at the end of or during the reporting period, or to income or expenses for the reporting period; and

(b) is useful to users.

2.36 An entity does not usually disclose in its financial statements other types of forward-looking information—for example, explanatory material about management's expectations and strategies.

Educational notes

The requirements to disclose possible future transactions or events direct management to use judgement to assess which possible events merit inclusion in the financial statements. Section 21 *Provisions and Contingencies* explicitly requires disclosure of contingent liabilities where the possibility of an outflow of resources is more than remote. This is a useful example of the assessment threshold. Section 21 also includes requirements on contingent assets.

The explicit permission not to disclose other types of forward-looking information helps to place boundaries on the requirements and shows that financial statements are only required to provide disclosures relating to recognised and unrecognised assets and liabilities, as well as equity, income and expenses.

Perspective adopted in financial statements

2.37 An entity discloses in its financial statements information about transactions and other events from the perspective of the entity as a whole, not that of any particular group of the entity's current or potential investors, lenders or other creditors.

Educational notes

Although the primary users of financial statements of SMEs are lenders and other creditors, and the IASB acknowledged their needs in developing the Standard, the financial statements themselves are prepared objectively and need to present a whole picture of the entity's financial position and financial performance. This approach ensures that the information required by other users is not obscured or misrepresented by the information of particular interest to, say, lenders. If information were to be directed towards the needs of a particular subset of primary users, it might be necessary to provide different sets of financial statements for each subset.

The requirement to provide information from the perspective of the entity as a whole reflects the IASB's view that the reporting entity is separate from its investors, lenders and other creditors.

Going concern assumption

2.38 An entity normally prepares its financial statements on the assumption that it is a **going concern** and will continue in operation for the foreseeable future. Users assume that the entity has neither the intention nor the need to enter liquidation or to stop trading. If the entity has such an intention or need, it might prepare the financial statements on another basis. If so, the entity describes in its financial statements the basis it has used (see paragraphs 3.8–3.9).

Educational notes

The Glossary states that an entity is a going concern unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

Section 2 does not provide further information on the use of a basis other than going concern, but preparers can look at Section 3. The Standard does not specify the meaning of 'the foreseeable future' but paragraph 3.8 of the Standard refers to it as 'at least, but not limited to, twelve months from the reporting date'. There might be variation among entities in how far forward management is reasonably able to predict because businesses have operating cycles of different lengths.

The reporting entity

2.39 A reporting entity is an entity that is required, or chooses, to prepare financial statements. A reporting entity is not necessarily a legal entity. A reporting entity can be a single entity, a portion of an entity or more than one entity.

2.40 If a reporting entity comprises both a **parent** and its **subsidiaries**, the reporting entity's financial statements are referred to as **consolidated financial statements**. If the reporting entity comprises two or more entities that are not linked by a parent–subsidiary relationship, the reporting entity's financial statements are referred to as **combined financial statements**.

2.41 The boundary of the reporting entity is based on users' information needs. Users need relevant information that faithfully represents what it purports to represent. Faithful representation requires that:

(a) the boundary of the reporting entity does not contain an arbitrary or incomplete set of economic activities;

(b) including that set of economic activities within the boundary of the reporting entity results in neutral information; and

(c) a description is provided of how the boundary of the reporting entity was determined and what constitutes the reporting entity.

Educational notes

Section 2 describes what a reporting entity is but does not state who must, should or could prepare general purpose financial statements. Section 9 *Consolidated and Separate Financial Statements* prescribes when an entity must prepare consolidated financial statements, and explains the process for preparing them. Paragraphs 2.39–2.40 support the Section 9 requirements by giving a conceptual justification for consolidated financial statements. Section 9 includes high-level disclosure requirements that are supplemented by paragraph 2.41 with its explicit requirement for a description of what constitutes the reporting entity.

Determining the boundary of a reporting entity is normally straightforward if that entity is a legal entity or if the entity comprises only legal entities all linked by a parent–subsidiary relationship. In those cases, the boundary of the legal entity (or entities) determines the boundary of the reporting entity. Determining the boundary in this way meets users' information needs. It is not always straightforward to establish whether there is a parent–subsidiary relationship, but Section 9 helps entities to assess whether they have control over another entity, with a rebuttable presumption that an entity holding a majority of another entity's voting rights controls that entity.

The elements of financial statements

2.42 The elements of financial statements are:

(a) assets, liabilities and equity, which relate to a reporting entity's **financial position**; and

(b) income and expenses, which relate to a reporting entity's financial **performance**.

2.43 These elements are linked to the economic resources, claims and changes in economic resources and claims discussed in paragraphs 2.6–2.7.

Educational notes

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 called the 'elements' of financial statements. The elements directly related to the measurement of financial position, which is shown in the statement of financial position (sometimes called the balance sheet), are assets, liabilities and equity. The elements directly related to the measurement of performance, which is shown in the statement of comprehensive income, are income and expenses. Income and expenses are defined with reference to changes in assets and liabilities. An entity's financial performance is reported in either its statement of comprehensive income or its income statement and statement of comprehensive income, as permitted by paragraph 5.2 of the Standard.

The presentation of the elements in the statement of financial position and the statement of comprehensive income involves a process of subclassification. For example, expenses may be classified by their nature or function in the business of the entity to display information in the manner that is reliable and most relevant to users (see paragraph 5.11). Current and non-current assets and current and non-current liabilities, however, are presented as separate classifications in the statement of financial position, except when a presentation based on liquidity provides information that is reliable and more relevant (see paragraph 4.4).

Definition of an asset

2.44 An asset is a present economic resource controlled by an entity as a result of past events.

2.45 An economic resource is a right that has the **potential to produce economic benefits**. It does not have to be certain, or even likely, that the right will produce economic benefits for the potential to exist; it is only necessary that the right exists.

2.46 Rights that have the potential to produce economic benefits take many forms, including:

(a) rights that correspond to an obligation of another party, for example:

(i) rights to receive **cash**.

(ii) rights to receive goods or services.

(iii) rights to exchange economic resources with another party on favourable terms. Such rights include, for example, a forward contract to buy an economic resource on terms that are currently favourable or an option to buy an economic resource.

(iv) rights to benefit from an obligation of another party to transfer an economic resource if a specified uncertain future event occurs.

(b) rights that do not correspond to an obligation of another party—for example, rights over physical assets, such as **property, plant and equipment** or **inventories**, or rights over some **intangible assets**.

2.47 Many rights are established by **contract**, legislation or similar means. For example, an entity might obtain rights from owning or leasing an object, from owning a debt instrument or an equity instrument, or from owning a registered patent. However, an entity might also obtain rights in other ways—for example:

(a) by acquiring or creating know-how not in the public domain; or

(b) through another party's obligation that arises because that other party has no practical ability to act in a manner inconsistent with its customary practices, published policies or specific statements.

2.48 An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that might flow from it. An entity has the present ability to direct the use of an economic resource if it has the right to deploy that economic resource in its activities, or to allow another party to deploy the economic resource in that party's activities. Control includes the present ability to prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it.

Educational notes

The definition of an asset has been updated from that in the second edition of the Standard. The Standard defines an asset as a present economic resource controlled by an entity as a result of past events. That economic resource is a right that has the potential to produce economic benefits.

Rights

Not all of an entity's rights are assets because to be the entity's assets, the rights need to be *controlled* by the entity and to have the potential to produce economic benefits for the entity beyond the economic benefits available to other parties.

Because an entity cannot have a right to obtain economic benefits from itself, investments in its own debt or equity, for example, treasury shares, are not assets of the entity.

Legal ownership of one physical object might give rise to several rights, such as the right to use the object and the right to sell rights over it. Usually when an item is a physical object, all the rights arising from legal ownership of it are treated as a single asset.

Potential to produce economic benefits

An asset could produce economic benefits for an entity by entitling or enabling it to do, for example, one or more of the following:

(a) receive contractual cash flows or another economic resource;

(b) exchange economic resources with another party on favourable terms;

(c) produce cash inflows or avoid cash outflows by, for example:

  (i) using the asset either individually or in combination with other economic resources to produce goods or provide services;

  (ii) using the asset to enhance the value of other economic resources; or

  (iii) leasing the asset to another party;

(d) receive cash or other economic resources by selling the asset; or

(e) extinguish liabilities by transferring the asset.

When an entity incurs expenditure, this is often, but not always, linked to obtaining an asset. Similarly, items can meet the definition of an asset without the entity incurring any expenditure, for instance when a government grants rights to the entity free of charge or another party donates assets to the entity in a non-exchange transaction.

Physical form is not essential to the existence of an asset—for example, licences, patents, copyrights and customer lists are assets if they have the potential to produce future economic benefits for the entity and they are controlled by the entity. Most financial assets (see the Glossary) are contractual rights.

Paragraphs 18.14–18.15 specifically prohibit the recognition of some intangible assets such as brands, mastheads, publishing titles, customer lists and items similar in substance that are internally generated.

Control

Control links an economic resource to an entity. An entity has the present ability to direct the use of an economic resource if it has the right to use that economic resource in its activities or to allow another party to do so.

Example—Cash

Ex 9 **An SME has cash.**

The cash is an asset of the SME. The SME controls the cash and, by definition, this gives it a right to economic benefits.

Examples—Assets with physical form

Ex 10 **An SME owns a machine that manufactures its products.**

The machine is a physical asset used in the production of goods. The machine has the potential to produce economic benefits for the SME because the goods the machine makes can be sold for cash. It therefore fits into the category in paragraph 2.46(b).

Ex 11 **An SME owns a fleet of motor vehicles. The vehicles are used by the sales staff in the performance of their duties to sell the SME's goods.**

The motor vehicles are physical assets used in the supply of goods. The motor vehicles have the potential to produce economic benefits for the SME in the form of cash inflows generated from the sale of its goods.

Ex 12 **An SME that manufactures goods owns a motor vehicle for the exclusive business use of its chief financial officer.**

The motor vehicle is a physical asset used in the administration of the SME. The motor vehicle has the potential to produce economic benefits for the SME in the form of the services provided by the chief financial officer.

Ex 13 **An SME owns a herd of cattle that form the breeding stock of its agricultural activities.**

The cattle are tangible assets used in the production of calves. The cattle have the potential to produce economic benefits for the SME in the form of cash inflows generated from the sale of the calves.

Ex 14 **An SME owns a building that it rents to independent third parties under operating leases in exchange for rental payments.**

The building is a physical asset used by the SME to earn lease rentals. The building has the potential to produce economic benefits for the SME in the form of lease rental payments.

Examples—Assets without physical form

Ex 15 **An SME owns a brand name that it purchased from a competitor. The brand name is legally protected through registration of a trademark with the local government.**

The brand name (a trademark) is an intangible asset of the SME. It has the potential to produce economic benefits for the SME in the form of future revenues from selling products and preventing its competitors from selling them. Control is evidenced by the legal right.

Ex 16 **An SME operates 20 taxis under licence in City A.**

The taxi licences are intangible assets of the SME. The licences have the potential to produce economic benefits for the SME in the form of taxi fares. The assets (taxi licences) are without physical substance (they are legal rights) but this does not prevent them from being classified as assets of the SME.

Ex 17 **SME A owns 100 ordinary shares that carry voting rights at a general meeting of shareholders of Entity B.**

The shares in Entity B are an investment asset of SME A and have the potential to produce economic benefits which could come in a number of ways, including future dividend cash inflows and/or proceeds from the disposal of shares and/or strategic or other synergistic or economic benefits from the relationship with Entity B. SME A has control over the shares (it decides whether to hold or sell them).

Definition of a liability

2.49 A liability is an entity's present obligation to transfer an economic resource as a result of past events.

2.50 A liability exists only if:

(a) an entity has an obligation;

(b) the obligation is to transfer an economic resource; and

(c) the obligation is a present obligation that exists as a result of past events.

2.51 An entity has an obligation if it has a duty or responsibility that the entity has no practical ability to avoid. An obligation is always owed to another party (or parties). It is not necessary for the entity to know the identity of the party (or parties) to whom the obligation is owed. Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. However, obligations can also arise from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is sometimes referred to as a **constructive obligation**.

2.52 A liability gives rise to an obligation to transfer an economic resource if the obligation has the potential to require an entity to transfer the economic resource to another party (or parties). It does not have to be certain, or even likely, that the entity will be required to transfer the economic resource for that potential to exist. It is only necessary that the obligation exists and that, in at least one circumstance, it would require the entity to transfer the economic resource.

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2.53 Obligations to transfer an economic resource include:

(a) obligations to pay cash;

(b) obligations to deliver goods or provide services;

(c) obligations to exchange economic resources with another party on unfavourable terms;

(d) obligations to transfer an economic resource if a specified uncertain future event occurs; and

(e) obligations to issue a **financial instrument** if that financial instrument obliges the entity to transfer an economic resource.

2.54 Instead of fulfilling an obligation to transfer an economic resource to the party that has a right to receive that resource, an entity might sometimes decide, for example:

(a) to settle the obligation by negotiating a release from the obligation;

(b) to transfer the obligation to a third party; or

(c) to replace that obligation to transfer an economic resource with another obligation by entering into a new transaction.

2.55 A present obligation exists as a result of past events only if an entity:

(a) has already obtained economic benefits or taken an action giving rise to the obligation; and

(b) will or might have to transfer an economic resource that it would not otherwise have had to transfer.

2.56 The economic benefits the entity obtained could include, for example, goods or services. The action the entity has taken could include, for example, operating a particular business or operating in a particular market. If the entity has obtained economic benefits, or has taken an action, over time, the resulting present obligation might accumulate over that time.

Educational notes

Obligation

When an entity has an obligation to transfer an economic resource, this means another party (or parties) has a right to receive that resource. However, this does not mean that the other party (or parties) will always recognise an asset at the same time as the entity recognises an obligation as a liability.

Many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The obligation that arises in such situations is sometimes referred to as a 'constructive obligation'. In some situations, an entity's duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity itself may take.

Transfer of an economic resource

An obligation can meet the definition of a liability even if there is only a low probability that it will transfer an economic resource. As with the definition of an asset, the definition of a liability in the revised Section 2 does not include a probability threshold; where appropriate, these thresholds are included in individual sections of the Standard.

Present obligation as a result of past events

A present obligation as a result of past events can arise even if the payment cannot be enforced until the future. For instance, an entity can have a contractual obligation to pay for goods it has received even if the supplier does not require payment until a future date. However, for the obligation to exist, the past events need to have taken place. For instance, if an entity has entered into a contract to pay an employee a salary in exchange for services, the entity does not have a present obligation until the services have been provided. Before that point, the contract is executory (refer to paragraphs 2.59–2.60 and the related educational notes).

Obligations that arise from future actions of the entity, no matter how likely, are not present obligations and therefore do not meet the definition of a liability. For example, it is inappropriate to recognise a liability for expected future losses because the entity has no present obligation to incur those losses. It is important to bear in mind, however, that the expectation of losses might be an indicator that some of the entity's assets might be impaired. Recognition of impairment losses is covered by Section 27 *Impairment of Assets*. Also, if an entity has entered into a contract that is onerous (see paragraph 21A.2 in the Appendix to Section 21) under which the entity has an unavoidable obligation to incur a loss, then recognising a liability for that loss is appropriate because it arises from a past event. This contract would be viewed as binding.

In accordance with some jurisdictions' financial reporting requirements, a liability called 'general reserves' for unspecified potential or future losses is recognised based on a notion of conservatism. These reserves do not meet the definition of a liability in the Standard because there is no present obligation to transfer an economic resource as a result of past events. Consequently, recognition as liabilities of such 'general reserves' is prohibited.

Examples—Liabilities

Ex 18 SME A has a contractual obligation to pay Entity B CU10,000 for goods that it received on 30 December 20X0 having purchased them on 30 days' credit from Entity B.

The trade payable is a financial liability of SME A because the purchase (and receipt) of the goods on credit created a present obligation (a contractual obligation) for SME A to pay, that is to transfer economic resources to, Entity B.

Ex 19 Waste from an SME's production process contaminated the groundwater at the SME's plant during the reporting period. The SME is required by law to restore the contaminated environment to its state before the activity began.

The SME has a liability because at the end of the reporting period, it has a present obligation enforceable by law to restore the damage caused to the environment (the past event). Restoring the environment is expected to result in a transfer of economic resources. *IFRS for SMEs* Accounting Standard—Educational Module 21 *Provisions and Contingencies* discusses the definition of a liability used in Section 21.

Ex 20 An SME has made a written pledge to contribute a substantial sum of money towards the construction of a new performing arts centre in its community. Executives of the SME appeared in a press conference to announce the pledge. With the SME's consent, the charitable organisation building the arts centre has cited the SME's pledge in its materials soliciting additional pledges for construction. Under local law, pledges to charitable organisations are not legally enforceable.

Although the pledge might not be legally enforceable, by participating in the press conference and allowing its name to be used in the solicitation, the SME has indicated that it has accepted an obligation to honour its pledge and has created a present obligation that the SME has no practical ability to avoid (its actions have given rise to a constructive obligation). Therefore the SME recognises a liability.

Examples—Not liabilities—No past event

Ex 21 An SME that operates ten petrol stations and owns the land and buildings for those stations chooses not to purchase fire insurance on those buildings but, rather, to 'self-insure' in case of fire loss. The SME can estimate reliably the statistical probability of the occurrence and the amount of the expected fire loss (loss of about CU100,000 once every ten years). The SME wants to recognise a liability of CU10,000 and related expense each year for the next ten years to reflect its expected loss. The SME reasons that if it had purchased insurance, it would recognise an expense in each reporting period.

The fact that the SME bears the risk of fire does not create an obligation, so there is no liability to recognise. No past event has occurred that would give rise to an obligation.

Ex 22 **A ski resort operator which is an SME operates in a cyclical business. Its earnings fluctuate from one year to the next, depending primarily on the weather. The management and owners of the SME believe that, because of earnings volatility, it is prudent to defer recognition of a portion of the profit in a 'good year' to the inevitable 'bad year' by recognising a provision in good years and reversing the provision in bad years. Also, the local income tax law allows deferral of a portion of the profit in a good year to help ensure that ski resort operators have cash to continue operating in bad years. The SME would like to recognise a provision in the financial statements equal to the amount that can be deferred for tax purposes.**

At the end of a good year, the SME has no obligation to transfer an economic resource as a result of past events. It is therefore inappropriate to recognise a provision under the Standard, because the definition of a liability is not met.

Assets and liabilities

Unit of account

2.57 The **unit of account** is the right or the group of rights, the obligation or the group of obligations, or the group of rights and obligations, to which an entity applies recognition criteria and measurement concepts.

2.58 An entity selects a unit of account for an asset or liability when it considers how recognition criteria and measurement concepts will apply to that asset or liability and to the related income and expenses. In some circumstances, it might be appropriate for the entity to select one unit of account for recognition and another unit of account for measurement. For example, an entity might sometimes recognise contracts individually, but measure them as part of a portfolio of contracts. For presentation and disclosure, an entity might aggregate or separate assets, liabilities, income and expenses into their components.

Educational notes

It is necessary to define the unit of account so that entities can apply accounting requirements at the right level. A unit of account is selected to provide useful information, which implies that:

(a) the information provided about the asset or liability and about any related income and expenses must be relevant. Treating a group of rights and obligations as a single unit of account might provide more relevant information than treating each right or obligation as a separate unit of account if, for example, those rights and obligations:

 (i) cannot be or are unlikely to be the subject of separate transactions;

 (ii) are all expected to expire in the same pattern;

(iii) have similar economic characteristics and risks and hence are likely to have similar implications for the prospects for future net cash inflows to the entity or net cash outflows from the entity; or

(iv) are used together in the business activities conducted by an entity to produce cash flows and are measured by reference to estimates of their interdependent future cash flows.

(b) the information provided about the asset or liability and about any related income and expenses must faithfully represent the substance of the transaction or other event from which they have arisen. Therefore, it might be necessary to treat rights or obligations arising from different sources as a single unit of account, or to separate the rights or obligations arising from a single source (see paragraph 2.58). Equally, to provide a faithful representation of unrelated rights and obligations, it might be necessary to recognise and measure them separately.

Selecting a unit of account takes into account the cost constraint. In general, the costs associated with recognising and measuring assets, liabilities, income and expenses increase as the size of the unit of account decreases. This means that rights or obligations arising from the same source are separated only if the resulting information is more useful and the benefits outweigh the costs.

Possible units of account include:

(a) an individual right or individual obligation;

(b) all rights, all obligations, or all rights and all obligations, arising from a single source, for example, a contract;

(c) a subgroup of those rights and/or obligations—for example, a subgroup of rights over an item of property, plant and equipment for which the useful life and pattern of consumption differ from those of the other rights over that item;

(d) a group of rights and/or obligations arising from a portfolio of similar items;

(e) a group of rights and/or obligations arising from a portfolio of dissimilar items—for example, a portfolio of assets and liabilities to be disposed of in a single transaction; and

(f) a risk exposure within a portfolio of items, because if a portfolio of items is subject to a common risk, some aspects of the accounting for that portfolio could focus on the aggregate exposure to that risk within the portfolio.

Trade receivables are financial assets but it would be unusual for an entity to look at credit risk on an invoice-by-invoice basis. Instead impairment might be assessed on a customer-by-customer basis.

The example in paragraph 2.58 about contracts illustrates different approaches to aggregation for different purposes. For instance progress might be assessed on a contract-by-contract basis but the entity might then group many contracts together for disclosures about types of revenue.

Executory contracts

2.59 An **executory contract** is a contract, or a portion of a contract, that is equally unperformed—neither party has fulfilled any of its obligations, or both parties have partly fulfilled their obligations to an equal extent.

2.60 An executory contract establishes a combined right and obligation to exchange economic resources. The right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are currently favourable; it has a liability if the terms of the exchange are currently unfavourable. Whether the entity includes such an asset or liability in its financial statements depends on both the recognition criteria and the **measurement basis** the entity selected for the asset or liability, including, if applicable, any test for whether the contract is onerous.

Educational notes

When either party fulfils its obligations under an executory contract, the contract is no longer executory. If the reporting entity fulfils its obligations first, its obligation to exchange economic resources becomes a right to receive an economic resource, so the entity recognises an asset. If the other party performs first, the reporting entity will have a liability.

An entity assessing whether an asset or liability should be recognised will look directly at the definitions of assets and liabilities in Section 2.

The exception is onerous contracts, that is, contracts where the unavoidable costs of meeting the obligations under the contract exceed the benefits expected to be received under it. Onerous contracts are discussed in *IFRS for SMEs* Accounting Standard—Educational Module 21 *Provisions and Contingencies*.

Definition of equity

2.61 Equity is the residual interest in an entity's assets after deducting all its liabilities.

Educational notes

Equity claims are claims on the residual interest in the assets of the entity after deducting all its liabilities. In other words, they are claims against the entity that do not meet the definition of a liability.

Examples—Equity

Ex 23 **On 31 December 20X0 an SME had equity share capital of CU100,000 in issue. In 20X1, the SME issued 50,000 equity shares at CU5 per share.**

At 31 December 20X1 the SME's equity included CU350,000 funds contributed by its shareholders (that is, CU100,000 at 31 December 20X0 + CU250,000 contributed in 20X1).

Ex 24 **On 31 December 20X0 SME A acquired 75% of Entity B for CU75,000 when the fair value of Entity B's net assets was CU100,000.**

On 31 December 20X0 in its consolidated financial statements, the group derecognises a CU75,000 asset (cash outflow for the investment) and recognises the net assets acquired at CU100,000. It also recognises in equity CU25,000 non-controlling interest. A non-controlling interest (NCI) is the equity in a subsidiary not attributable, directly or indirectly, to a parent. Consequently, it meets the definition of equity (that is, the residual interest in the assets of the entity after deducting all its liabilities).

A liability is an entity's present obligation to transfer an economic resource as a result of past events. NCI holders are typically in the same position as other shareholders and the entity therefore has no present obligation to pay them, so an NCI is not a liability. This would not, however, always be the case (for example if the NCI holders have the right to put their shares to the entity).

Ex 25 **Since its formation, a parent entity has owned 75% of an entity's share capital and 25% is owned by an independent third party. The parent entity has assessed that it controls the entity. In the current reporting period, when the subsidiary's equity was CU100,000 (that is, share capital of CU1,000 and retained earnings of CU99,000), the parent acquired the remaining 25% of the shares in its subsidiary at their fair value of CU60,000.**

From the group's perspective, the purchase of the shares in its subsidiary from the third party (a non controlling interest) is a transaction between equity holders. Consequently, no gain or loss results from the transaction. However, the group would derecognise the asset 'cash' (that is, CU60,000 paid to the non controlling interest) and derecognise the CU25,000 equity item 'non-controlling interest'. Consequently, it would also reduce another component of equity (for example, retained earnings) by CU35,000. The entries would represent a reallocation within equity and would be presented in the Statement of Changes in Equity (see *IFRS for SMEs* Accounting Standard—Educational Module 6 *Statement of Changes in Equity and Statement of Income and Retained Earnings*).

Ex 26 On the retirement of one of the owner–managers of an SME on 31 December 20X0, the SME repurchased the shares held by the retiree at their fair value of CU1,000.

The use of CU1,000 cash to buy back shares is a return of capital to shareholders and is therefore treated as a distribution and recognised as a decrease in equity.

The SME's own shares are not an asset of the SME. Instead, the shares are an interest in the SME's assets. Consequently, the own shares acquired are not recognised as an asset because they lack the essential feature of an asset, namely, the potential to produce future economic benefits for the SME. The future economic benefits usually provided by an interest in shares are dividends and an increase in the value of the shares. When an SME has an interest in its own shares, it will receive dividends on those shares only if it elects to pay them, and such dividends do not represent a gain to the SME, because there is no change in net assets (the flow of funds is simply circular).

Ex 27 The facts are the same as in Example 26. However, in this example, on 1 January 20X2 the SME issued the shares to a previously independent third party who simultaneously became an owner–manager of the SME in exchange for CU1,200 (the then fair value of the shares).

The SME's own shares, while held by the SME, are recognised as a decrease of CU1,000 in equity. On 1 January 20X2 the CU1,200 inflow of cash on the transfer of those shares to the incoming owner–manager is recognised as an increase in shareholders' equity. No revenue or expense would be recognised from the sale of those shares.

Definitions of income and expenses

2.62 Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of **equity claims**.

2.63 Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity other than those relating to distributions to holders of equity claims.

2.64 Income and expenses are the elements of financial statements that relate to an entity's financial performance. Users need information about both an entity's financial position and its financial performance. Although income and expenses are defined in terms of changes in assets and liabilities, information about income and expenses is just as important as information about assets and liabilities.

2.65 Transactions and other events generate income and expenses with varied characteristics. Separating information about income and expenses that have differing characteristics can help users understand the entity's financial performance.

Educational notes

Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. Information about the return the entity has produced can help users to assess management's stewardship of the entity's economic resources. Information about the variability and components of that return is also important, especially in assessing the uncertainty of future cash flows. Information about a reporting entity's past financial performance and how its management discharged its stewardship responsibilities is usually helpful in predicting the entity's future returns on its economic resources.

Financial performance is measured as the net of all income and expenses for the period (total comprehensive income), which is determined by reference to all changes in assets and liabilities in the period (except for those associated with equity transactions). The term comprehensive income (rather than profit or loss or net income) is used because the Standard requires some (and permits other) specified items of income and expense to be recognised outside of profit or loss in the statement of comprehensive income.

Information about a reporting entity's financial performance during a period might also indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows.

Examples—Revenue or gain?

Ex 28 On 31 December 20X5 an SME sold inventory to a customer for CU1,500 when the carrying amount of the inventory was CU1,000.

On 31 December 20X5 the SME recognises CU1,500 revenue from the sale of goods and CU1,000 expense (costs of goods sold). See also paragraph 13.20 of the Standard.

Ex 29 On 31 December 20X5 an SME sold a machine used by the SME in the manufacture of goods for CU1,500 when the carrying amount of the machine was CU1,000.

On 31 December 20X5 the SME recognises a *gain* on the disposal of the machine of CU500 (see also paragraphs 17.28 and 17.30).

Calculation: CU1,500 selling price minus CU1,000 carrying amount derecognised on sale equals CU500 gain on disposal of machine. The gain is a net amount (that is, income minus expense).

Examples—Expense or loss?

Ex 30 On 31 December 20X5 an SME sold inventory to a customer for CU1,000 when the carrying amount of the inventory was CU1,100.

On 31 December 20X5 the SME recognises CU1,000 income (revenue from the sale of goods) and CU1,100 *expense* (costs of goods sold).

Ex 31 **On 31 December 20X5 an SME sold a machine used by the SME in the manufacture of goods for CU900 when the carrying amount of the machine was CU1,000.**

On 31 December 20X5 the SME recognises a *loss* on the disposal of the machine of CU100 in profit or loss (see also paragraphs 17.28 and 17.30).

Calculation: CU900 selling price minus CU1,000 carrying amount derecognised on sale equals CU100 loss on disposal of machine. The loss is a net amount.

Recognition and derecognition

The recognition process

2.66 Recognition is the process of capturing assets, liabilities, equity, income and expenses in the **statement of financial position** or the statement(s) of financial performance.[3] Recognition involves depicting the item—either alone or in **aggregation** with other items—in words and by a single monetary amount in one of those statements and including that amount in one or more totals in that statement. The **carrying amount** is the amount at which an entity recognises an asset, a liability or equity in the statement of financial position.

[footnote 3 reads:
The *IFRS for SMEs* Accounting Standard does not specify whether the statement(s) of financial performance comprise(s) a single statement or two statements. The term 'statement of profit or loss' refers to both a separate statement and a separate section within a single statement of financial performance.]

2.67 Recognition links the elements of financial statements, the statement of financial position and the statement(s) of financial performance (see Figure 2.1). In the statement of financial position at the beginning and end of the reporting period, total assets minus total liabilities equals total equity. Recognised changes in equity during the reporting period comprise:

(a) income minus expenses recognised in the statement(s) of financial performance; plus

(b) contributions from holders of equity claims minus distributions to holders of equity claims.

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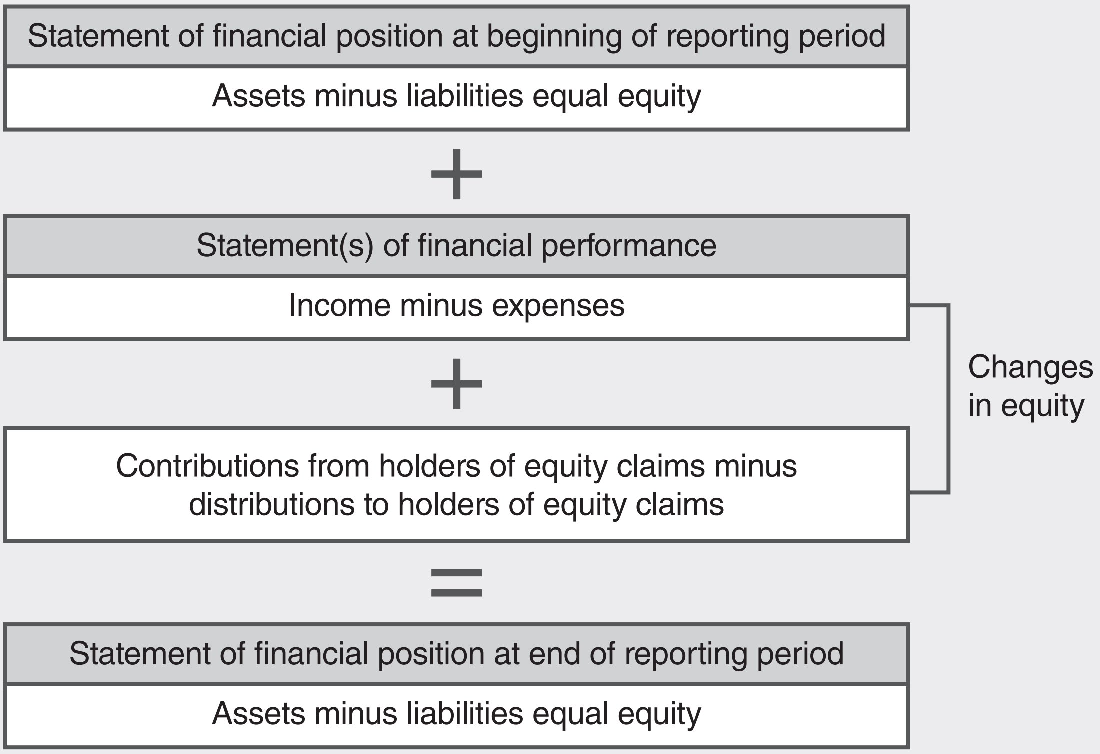
Figure 2.1—How recognition links the elements of financial statements



Educational notes

The statements of financial position and financial performance are linked because recognising one item (or changing an item's carrying amount) requires another item to be recognised or derecognised (or requires another item's carrying amount to change).

Recognising income and related expenses at the same time is sometimes referred to as 'matching costs with income', and often arises as a consequence of applying the principles in Section 2. However, matching costs with income is not an objective of Section 2. Section 2 does not allow entities to recognise items in the statement of financial position if they do not meet the definition of an asset, a liability or equity.

Example—How recognition links the elements of financial statements

Ex 32 An SME provides a service and recognises revenue.

At the same time as it recognises revenue, the SME recognises a trade receivable. Later, when payment is received, the SME derecognises the trade receivable and recognises a new asset, cash. The statement of cash flows is discussed in *IFRS for SMEs* Accounting Standard—Educational Module 7 *Statement of Cash Flows*.

Recognition criteria

2.68 Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position. Similarly, only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance. However, not all items that meet the definition of one of those elements are recognised.

2.69 An entity cannot correct its failure to recognise an item that satisfies the recognition criteria by disclosing the **accounting policies** it used or by providing **notes** or explanatory material.

Educational notes

An asset or liability is recognised only if that recognition provides users of the financial statements with information that is useful, meaning it is relevant and faithfully represents the asset or liability and any resulting income, expenses or changes in equity.

Even if an item meeting the definition of an asset or liability is not recognised because it does not meet the criteria, an entity might need to provide information about the item in the notes to the financial statements.

The approach to recognition differs from that in the previous version of Section 2, which required that assets and liabilities be recognised only if it was probable that associated future economic benefits would flow to or from the entity and if the asset or liability could be reliably measured. Instead, the requirements in individual sections of the Standard will assist entities in establishing whether the definition is met (for instance, Section 21 provides information about when a present obligation gives rise to a liability to be recognised as a provision). Individual sections will also help preparers to decide whether the asset or liability should be recognised by assessing relevance and faithful representation, considering existence uncertainty and measurement uncertainty respectively. Examples of situations where an entity would need to look at both Section 2 and Section 18 are provided in *IFRS for SMEs* Accounting Standard—Educational Module 18 *Intangible Assets other than Goodwill*.

Relevance

2.70 Information about assets, liabilities, equity, income and expenses is relevant to users. However, recognition of a particular asset or liability and any resulting income, expenses or changes in equity might not always provide relevant information. For example, if it is uncertain whether an asset or liability exists, or if an asset or liability exists but the probability of an inflow or outflow of economic benefits is low, information about that asset or liability might not be relevant. However, that information could be relevant in combination with other factors.

Existence uncertainty

2.71 In some cases, it might be unclear whether an asset or liability exists. That uncertainty, which might coincide with a low probability of inflows or outflows of economic benefits and an exceptionally wide range of possible outcomes, might mean that recognising a single asset or liability would not provide relevant information. Whether or not an entity has recognised the asset or liability, the entity might need to provide explanatory information in the financial statements about the associated uncertainties.

Educational notes

When there is a low probability of an inflow or outflow of economic benefits, recognising the asset or liability in combination with other factors might still provide relevant information.

Section 21 includes requirements relating to contingent assets and contingent liabilities that entities will apply when relevant, to establish whether the definition of an asset or liability is met and, if so, whether the information is relevant and faithfully represents the transaction. Examples illustrating these judgements are included in the *IFRS for SMEs* Accounting Standard—Educational Module 21 *Provisions and Contingencies*.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. The requirement that contingent assets are recognised only if the flow of future economic benefits to the entity is virtually certain creates a higher hurdle for recognition than for other types of assets.

Faithful representation

2.72 Recognition of a particular asset or liability is appropriate if it provides not only relevant information, but also a faithful representation of that asset or liability and of any resulting income, expenses or changes in equity. Whether an entity can provide a faithful representation might be affected by the level of **measurement uncertainty** associated with the asset or liability or by other factors.

Measurement uncertainty

2.73 An entity measures an asset or liability in order to recognise it. In many cases, an entity estimates this measurement and it is therefore subject to measurement uncertainty. Using estimates is an essential part of preparing financial information and does not undermine the usefulness of the information if an entity clearly and accurately describes and explains the estimates.

2.74 An item that fails to meet the recognition criteria might later qualify for recognition as a result of circumstances or events.

2.75 Whether or not an entity recognises an asset or liability, the entity might need to include explanatory information to provide a faithful representation of the asset or liability. The entity could include information about the uncertainties associated with the asset or liability's existence or measurement, or with its outcome—the amount or timing of any inflow or outflow of economic benefits that will ultimately result from the asset or liability (see paragraphs 2.108–2.109).

Educational notes

Sometimes measurement uncertainty will be so high that recognising an asset or liability might result in an entity being unable to provide a faithful representation. This might arise, for instance:

(a) when there is a very wide range of possible outcomes and the probability of each outcome is difficult to estimate;

(b) when the measure is sensitive to small changes in estimates of the probability of different outcomes; or

(c) when measuring the asset or liability requires a very difficult or subjective allocation of cash flows (for instance, when estimating an impairment loss on assets in a cash-generating unit, see *IFRS for SMEs* Accounting Standard—Educational Module 27 *Impairment of Assets*).

When high measurement uncertainty exists, the most useful information might be the measure that relies on the highly uncertain estimate, accompanied by a description of the estimate and an explanation of the uncertainties that affect it, in the notes to the financial statements. This is especially likely to be the case if that measure is the most relevant of the measures available. In other cases, the most useful information might be a different measure (accompanied by suitable descriptions and explanations) that is slightly less relevant but is subject to lower measurement uncertainty.

Example—Measurement uncertainty

Ex 33 **An SME has developed a successful brand that allows the SME to charge a premium for its products. The SME continues to spend large amounts of money on maintaining and developing the brand (for example, sponsoring local sports events, sponsoring cultural events and advertising the brand).**

The brand meets the definition of an asset in Section 2 because there is a present economic resource controlled by the SME arising from past events. However, the nature of the ongoing maintenance and development costs might mean it is difficult to reliably measure the cost of the brand. The brand's value might also be difficult to measure reliably and an entity, therefore, might be unable to provide a faithful representation.

The internal costs incurred in initially developing the brand do not satisfy the specific recognition criteria in paragraph 18.4. The expenditure incurred for sponsorships and advertising to maintain the brand are not recognised as an intangible asset because they result from expenditure incurred internally on an intangible item. The SME recognises the costs as an expense as they are incurred (see paragraphs 18.4(c), 18.14 and 18.15 of the Standard).

Derecognition

2.76 **Derecognition** is the removal of all or part of a recognised asset or liability from an entity's statement of financial position. Derecognition normally occurs if that item no longer meets the definition of an asset or a liability. For example:

(a) for an asset, derecognition normally occurs if the entity loses control of all or part of the recognised asset; and

(b) for a liability, derecognition normally occurs if the entity no longer has a present obligation for all or part of the recognised liability.

2.77 Accounting requirements for derecognition in this Standard aim for an entity to faithfully represent any assets and liabilities it retained after a transaction or other event that led to derecognition and the change in the entity's assets or liabilities as a result of that transaction or other event.

2.78 To achieve the aim described in paragraph 2.77, an entity normally:

(a) derecognises any of its assets or liabilities that have expired or have been consumed, collected, fulfilled or transferred, and recognises any resulting income and expenses; and

(b) continues to recognise any of its retained assets or liabilities.

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2.79 To achieve the aim described in paragraph 2.77, an entity can:

(a) present the retained component separately in the statement of financial position;

(b) present separately in the statement(s) of financial performance any income and expenses the entity recognised as a result of the derecognition of the transferred component; or

(c) provide explanatory information.

Educational notes

In some cases, an entity might appear to transfer an asset or liability but that asset or liability might nevertheless remain an asset or liability of the entity, so derecognition would not be appropriate. For example:

(a) if an entity has apparently transferred an asset but retains exposure to significant positive or negative variations in the amount of economic benefits that might be produced by the asset, this might indicate that the entity continues to control that asset; or

(b) if an entity has transferred an asset to another party that holds the asset as an agent for the entity, the entity still controls the asset.

Measurement

2.80 An entity quantifies elements recognised in financial statements in monetary terms. To quantify an element, an entity first selects a measurement basis.

2.81 A measurement basis is an identified feature—for example, historical cost, **fair value** or fulfilment value—of the item being measured. Applying a measurement basis to an asset or liability creates a **measure** for that asset or liability and for related income and expenses.

2.82 The appropriate measurement basis is specific to the item being measured.

Educational notes

Consideration of the qualitative characteristics of useful financial information and of the cost constraint is likely to result in the selection of different measurement bases for different assets, liabilities, income and expenses.

To a large extent, measurements are based on estimates, judgements and models rather than on exact depictions. Section 2 establishes the concepts that underlie those estimates, judgements and models.

Measurement bases

Historical cost

2.83 Historical cost measures provide monetary information about assets, liabilities and related income and expenses using information an entity derived, at least in part, from the price of the transaction or other event that gave rise to them.

2.84 The historical cost of an asset is the value of the costs incurred in acquiring or creating the asset, comprising the consideration an entity paid to acquire or create the asset plus **transaction costs**. The historical cost of a liability is the value of the consideration the entity received to incur or take on the liability minus transaction costs.

2.85 An entity updates over time the historical cost of an asset to depict, if applicable:

(a) the consumption of part or all of the economic resource that constitutes the asset (**depreciation** or **amortisation**);

(b) any payments received for part or all of the asset;

(c) the effect of events that cause part or all of the historical cost of the asset to no longer be recoverable (**impairment**); and

(d) the accrual of interest to reflect any financing component of the asset.

2.86 An entity updates over time the historical cost of a liability to depict, if applicable:

(a) the fulfilment of part or all of the liability—for example, by making payments that diminish part or all of the liability or by satisfying an obligation to deliver goods or services.

(b) the effect of events that increase the value of the obligation to transfer the economic resources needed to fulfil the liability to the extent that the liability becomes onerous. A liability is onerous if the historical cost is no longer enough to depict the obligation to fulfil the liability.

(c) the accrual of interest to reflect any financing component of the liability.

2.87 One way an entity applies a historical cost measurement basis to **financial assets** and **financial liabilities** is to measure them at amortised cost. The **amortised cost of a financial asset or financial liability** reflects estimates of future cash flows discounted at the rate the entity determined at initial recognition. For variable rate instruments, the entity updates the discount rate to reflect changes in the variable rate. Over time, the entity updates the amortised cost of a financial asset or financial liability to depict changes such as the accrual of interest, the impairment of a financial asset and receipts or payments.

Educational notes

Other measurement methods required or permitted for assets and liabilities in the Standard include estimated selling price less costs to complete and sell for impaired inventories and recoverable amount for impaired non-current assets.

Sometimes individual assets (and liabilities) are measured using a combination of measurement methods. For example, when the commodity price risk of a commodity held is hedged, the change in the fair value of the commodity held (related to the commodity price risk) is adjusted to the carrying amount (cost) of the commodity held (the hedged item).

Current value

2.88 Measurements based on current value provide monetary information about assets, liabilities and related income and expenses using information updated to reflect conditions at the measurement date. Current value measurement bases include:

(a) fair value;

(b) current cost;

(c) **value in use** for assets; and

(d) fulfilment value for liabilities.

2.89 Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an **orderly transaction** between **market participants** at the measurement date. Because fair value is not derived, even in part, from the price of the transaction or other event that gives rise to the asset or the liability, fair value is not increased by transaction costs an entity incurs when acquiring the asset and is not decreased by the transaction costs an entity incurs when it takes on the liability.

2.90 Current cost is the cost of an equivalent asset at the measurement date, comprising the consideration an entity would pay at the measurement date plus the transaction costs the entity would incur at that date. The current cost of a liability is the consideration an entity would receive for an equivalent liability at the measurement date minus the transaction costs the entity would incur at that date.

2.91 Value in use is the **present value** of the cash flows or other economic benefits that an entity expects to derive from the use of an asset and from its ultimate disposal. Fulfilment value is the present value of the cash or other economic resources that an entity expects to be obliged to transfer when it fulfils a liability. Because value in use and fulfilment value are based on future cash flows, they do not include transaction costs incurred when an entity acquires an asset or takes on a liability.

Educational notes

Fair value might be easy to determine by observing prices in an active market. In other cases, an entity will need to use measurement techniques, such as cash-flow-based techniques, that take into account:

(a) estimated future cash flows;

(b) possible variations in the estimated amount or timing of these flows;

(c) the time value of money;

(d) risk premium or discount (representing the price for bearing uncertainty); and

(e) other factors.

Section 12 *Fair Value Measurement* provides guidance on measuring the fair value of financial and non-financial assets and liabilities.

Current cost is often observable but might not always be. If, for example, prices are only available for new assets and the entity's asset is several years old, the entity might need to adjust the new price to reflect the asset's age and condition.

Value in use and fulfilment value both reflect entity-specific assumptions, not assumptions by market participants. Neither can be observed directly; instead they use cash-flow-based measurement techniques. The main difference between these measures and fair value (if determined using a cash-flow-based measurement technique) is their use of entity-specific information instead of market-specific information.

Information provided by particular measurement bases

2.92 When an entity selects a measurement basis, it considers the nature of the information that the measurement basis will produce in both the statement of financial position and the statement(s) of financial performance.

Historical cost

2.93 If an entity measures an asset or liability at historical cost, the resulting information might be relevant to users because historical cost uses information derived, at least in part, from the price of the transaction or other event that gave rise to the asset or liability. Because an entity reduces historical cost to reflect consumption of an asset and its impairment, the amount expected to be recovered from an asset measured at historical cost is at least as great as its carrying amount. Similarly, because an entity increases the historical cost of a liability when the liability becomes onerous, the value of the obligation to transfer the economic resources needed to fulfil the liability is no more than the carrying amount of the liability.

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Current value

2.94 If an entity measures an asset or liability at fair value, the resulting information might have predictive value because fair value reflects market participants' current expectations about the amount, timing and uncertainty of future cash flows.

2.95 If an entity measures an asset using value in use, the resulting information is about the present value of the estimated cash flows from the use of the asset and from its ultimate disposal. This information might have predictive value because it can be used in assessing the prospects for future net cash inflows.

2.96 If an entity measures a liability using fulfilment value, the resulting information is about the present value of the estimated cash flows needed to fulfil the liability. This information might have predictive value, particularly if the entity expects to fulfil the liability instead of transferring it or settling it by negotiation.

2.97 If an entity provides updated estimates of value in use or fulfilment value, combined with information about estimates of the amount, timing and uncertainty of future cash flows, that information might help verify previous estimates of value in use or fulfilment value.

2.98 If an entity measures an asset or liability using current cost, the resulting information might be relevant because current cost reflects the cost at which an equivalent asset could be acquired or created at the measurement date or the consideration that would be received from incurring or taking on an equivalent liability.

Educational notes

If an asset that is not a financial asset is measured at historical cost, then when part or all of the asset is consumed or sold, the associated expense is also measured at historical cost. The difference between the income and expense is the margin resulting from the sale.

When an asset held at fair value is sold, the sale would usually be at fair value (that is, if the transaction were to occur in the market that was the source for the prices used when measuring that fair value) so the net income or expense from that sale would be small.

Factors to consider when selecting a measurement basis

2.99 When an entity selects a measurement basis for an asset or liability and for the related income and expenses, the entity considers the nature of the information that the measurement basis will produce in both the statement of financial position and the statement(s) of financial performance.

2.100 In most cases, an entity will not select a measurement basis based on a single factor. The relative importance of each factor depends on the facts and circumstances of the item being measured.

2.101 An entity selects a measurement basis that will provide useful information to users. To be useful, the information is relevant and faithfully represents what it purports to represent. In addition, the information should be comparable, verifiable, timely and understandable, to the extent possible.

Relevance

2.102 The relevance of information an entity provides using a measurement basis is affected by:

(a) the characteristics of the asset or liability, in particular the variability of cash flows and whether the value of the asset or liability is sensitive to market factors or other risks; and

(b) how that asset or liability contributes to future cash flows.

2.103 If the value of an asset or liability is sensitive to market factors or other risks, its historical cost might differ significantly from its current value. Consequently, historical cost might not provide relevant information if information about changes in value is important to users.

2.104 For assets and liabilities that produce cash flows directly, such as assets that can be sold independently and without a substantial economic penalty (for example, without substantial business disruption), the measurement basis that provides the most relevant information is likely a current value that takes into account current estimates of the amount, timing and uncertainty of the future cash flows. For assets and liabilities that do not produce cash flows directly, an entity considers the principles of relevance and faithful representation to the extent that they apply to the facts and circumstances.

2.105 If an entity's business activity involves managing financial assets and financial liabilities with the objective of collecting contractual cash flows, amortised cost might provide relevant information that can be used to derive the margin between the interest earned on the assets and the interest incurred on the liabilities.

Educational notes

Some economic resources produce cash flows directly; in other cases, economic resources are used in combination to produce cash flows indirectly. How economic resources are used, and hence how assets and liabilities produce cash flows, depends in part on the nature of the business activities conducted by the entity.

When a business activity of an entity involves the use of several economic resources that produce cash flows indirectly, by being used in combination to produce and market goods or services to customers, historical cost or current cost is likely to provide relevant information about that activity. For example, property, plant and equipment is typically used in combination with an entity's other economic resources. Similarly, inventory typically cannot be sold to a customer without making use of the entity's other resources (for example, in production and marketing activities).

For assets and liabilities that produce cash flows directly, such as assets that can be sold independently and without a significant economic penalty, the measurement basis that provides the most relevant information is likely to be a current value that incorporates current estimates of the amount, timing and uncertainty of the future cash flows.

Faithful representation

2.106 In some circumstances, an entity uses the same measurement basis for related assets and liabilities to provide users with more useful information than the information that would result from using different measurement bases—for example, if the entity's cash flows from one asset or liability are directly linked to its cash flows from another asset or liability.

2.107 As noted in paragraph 2.18, although a perfectly faithful representation is free from error, measures do not have to be perfectly accurate.

2.108 Measurement uncertainty arises if an entity estimates an item's value because it cannot measure the item by observing prices in an **active market**. The level of measurement uncertainty associated with a particular measurement basis might affect whether the information an entity provides using that measurement basis is a faithful representation of the entity's financial position and financial performance. A high level of measurement uncertainty does not necessarily prevent an entity from using a measurement basis that provides relevant information, but in some cases, the level is so high that such information might not lead to a sufficiently faithful representation. In these cases, an entity should consider selecting another measurement basis that would also result in relevant information.

2.109 Measurement uncertainty is not the same as **outcome uncertainty** and **existence uncertainty**. Outcome uncertainty arises when there is uncertainty about the amount or timing of any inflow or outflow of economic benefits that will result from an asset or liability. Existence uncertainty arises when an asset or a liability's existence is uncertain. Paragraphs 2.70–2.71 discuss how existence uncertainty might affect an entity's decisions to recognise an asset or liability when the entity is uncertain about whether that asset or liability exists.

Educational notes

All estimates will give rise to some level of measurement uncertainty, and judgement is needed in deciding whether this uncertainty is too much. Paragraph 8.6 of the Standard requires disclosure of key sources of estimation uncertainty.

The most efficient and effective process for applying the fundamental qualitative characteristics would usually be to identify the most relevant information about an economic phenomenon. If that information is not available or cannot be provided in a way that faithfully represents the economic phenomenon, an entity should consider the next most relevant type of information.

Enhancing qualitative characteristics and the cost constraint

2.110 The enhancing qualitative characteristics of comparability, understandability and verifiability, and the cost constraint, affect an entity's selection of a measurement basis. The enhancing qualitative characteristic of timeliness has no specific implications for measurement.

2.111 Consistently using the same measurement bases for the same items, either from period to period within a reporting entity or in a single period across entities, can help make financial statements more comparable.

2.112 If an entity changes the measurement basis it uses, its financial statements might be less understandable. However, a change might be justified if, for example, the change results in more relevant information. If an entity changes the measurement basis it uses, users might need explanatory information to understand the effect of that change.

2.113 Understandability depends partly on how many measurement bases an entity uses and whether its use of those bases changes over time. In general, the more measurement bases an entity uses, the more complex the resulting information. Consequently, the information becomes less understandable and the totals or subtotals in the statement of financial position and the statement(s) of financial performance become less informative. However, it could be appropriate for an entity to use more measurement bases if doing so provides useful information.

2.114 Verifiability is improved when an entity uses measurement bases that result in information that can be independently corroborated, either directly (for example, by observing prices) or indirectly (for example, by checking inputs to a model). If a measure cannot be verified, an entity might provide explanatory information to enable users to understand how the entity determined the measure.

Educational notes

The appropriate measurement basis to use will depend on the asset or liability. Often, measuring historical cost is simpler and less costly when compared to using current cost. Also, users often find historical cost understandable and it is often verifiable. However, the use of historical cost can reduce comparability.

Current value measures such as fair value can enhance comparability because they use market-based, not entity-specific, data. Measuring fair value can also be simple and low in cost if the fair value is based on observing prices in an active market. However, using valuation techniques to determine fair value can be costly and involve management judgement.

A current cost measurement basis is also helpful for comparability but it is not always cost-effective to determine current cost, particularly if an entity cannot find a current market price so instead has to estimate current cost by adjusting the current price of a new asset to reflect an asset's current age or condition.

At initial recognition, the cost of an asset is normally the same as its fair value, but it is still important to decide what basis will formally be used as the measurement basis because this affects subsequent measurement.

When assets are obtained other than on market terms, it might be necessary to account for both the purchase of an asset and another transaction.

Example—An asset obtained not on market terms

Ex 34 **An SME acquires a piece of machinery for CU700,000 from one of its shareholders. The machinery has a market price of CU1,000,000 and the shareholder gave a discount because of its relationship with the SME.**

Recording the asset at CU700,000 would not provide a faithful representation of the asset. Instead the SME initially measures the asset at CU1,000,000 with CU300,000 recognised as a shareholder contribution recorded in equity, representing the difference between the cash paid and the asset's fair value at acquisition.

Measurement of equity

2.115 An entity does not directly measure the total carrying amount of equity (total equity). The total of the carrying amounts of all recognised assets minus the total of the carrying amounts of all recognised liabilities equals the total equity.

2.116 Although an entity does not directly measure total equity, the entity might directly measure the carrying amount of some individual classes of equity and some components of equity.

Educational notes

Share capital is an example of a component of equity that can be measured directly.

Because general purpose financial statements do not have the objective of showing an entity's value, the total carrying amount of equity does not usually equal:

(a) the aggregate market value of equity claims on the entity;

(b) the amount that could be raised by selling the entity as a whole on a going concern basis; or

(c) the amount that could be raised by selling all of the entity's assets and settling all of its liabilities.

The total carrying amount of an individual class of equity or component of equity is normally positive, but it can be negative in some circumstances. Similarly, total equity is generally positive, but it can be negative, depending on which assets and liabilities are recognised and on how they are measured.

Presentation and disclosure

Presentation and disclosure as communication tools

2.117 A reporting entity communicates information about its assets, liabilities, equity, income and expenses by presenting and disclosing information in its financial statements.

2.118 An entity that effectively presents and discloses information in its financial statements makes that information more relevant, understandable and comparable. Effective presentation and disclosure also contribute to faithful representation of the entity's assets, liabilities, equity, income and expenses.

2.119 Just as cost constrains other financial reporting decisions, it also constrains an entity's decisions about presentation and disclosure. When an entity decides how to present and disclose information, it is important that the entity considers whether the benefits to users justify the costs of providing and using that information.

Educational notes

To allow entities to communicate effectively in their financial statements, the Standard's requirements balance:

(a) giving entities enough flexibility to provide relevant information that faithfully represents their assets, liabilities, equity, income and expenses; and

(b) requiring information that is comparable between periods for the reporting entity, and between reporting entities for the same period.

There are two more principles that also support effective communication, namely:

(a) entity-specific information is more useful than standardised 'boilerplate' descriptions; and

(b) information being duplicated in different parts of the financial statements can make those financial statements less understandable.

For an SME, the costs of providing information and benefits to users might not be the same as for a publicly accountable entity. The IASB considered these factors when deciding which requirements to use in the Standard, and SMEs will also need to use judgement in presenting and disclosing information.

Classification

2.120 **Classification** is the sorting of assets, liabilities, equity, income or expenses on the basis of shared characteristics for presentation and disclosure purposes. Such characteristics include the nature of the item, its role (or function) within the entity's business activities and how the entity measures it.

2.121 Classifying dissimilar assets, liabilities, equity, income or expenses together can obscure relevant information, reduce understandability and comparability and might not result in a faithful representation of what the information purports to represent.

2.122 An entity applies the classification to the unit of account the entity selected for an asset or liability. However, an entity separates an asset or liability's components by characteristic and classifies those components separately if the resulting financial information is more useful.

2.123 An entity classifies income and expenses and includes them either:

(a) in the statement of **profit or loss**; or

(b) in **other comprehensive income**.

2.124 The statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period. Therefore, in principle, an entity includes all income and expenses in that statement. An entity presents items of income or expense in other comprehensive income only if explicitly permitted or required by this Standard.

2.125 In principle, an entity reclassifies income and expenses it included in other comprehensive income in one period into the statement of profit or loss in a future period if doing so results in the statement of profit or loss providing more relevant information or providing a more faithful representation of the entity's financial performance, for that future period. Individual sections of this Standard might describe situations in which an entity is permitted or required to reclassify income and expenses included in other comprehensive income.

Offsetting

2.126 **Offsetting** occurs when an entity recognises and measures both an asset and a liability as separate units of account, but groups them into a single net amount in the statement of financial position. Offsetting classifies dissimilar items together and therefore is generally not appropriate unless required or permitted by a specific section of this Standard.

Examples—Offsetting required

Ex 35 **On 1 November 20X5 an SME sold an owner-occupied building for CU3.5 million. The building had a carrying amount of CU2 million at the date of sale. The estate agent retained a commission of 10% of the sale proceeds. Legal fees in respect of the sale were CU10,000.**

On 1 November 20X5 the SME recognises a gain on the disposal of the building of CU1,140,000 in profit or loss, calculated and recognised in accordance with paragraph 17.30.

Calculation: CU3,500,000 selling price - CU350,000 agent's commission - CU10,000 legal fees = CU3,140,000 net disposal proceeds.

CU3,140,000 net disposal proceeds - CU2,000,000 carrying amount = CU1,140,000 gain on disposal of building.

Ex 36 **An SME offers a defined benefit pension plan to its employees which provides a monthly pension of 0.2% of final salary for each year of service. The pension is payable from the age of 65. At 31 December 20X1 the present value of the SME's obligations under the plan was estimated at CU200,000. Furthermore, the fair value of the plan assets, out of which the obligations are to be settled directly, was determined to be CU180,000 as at 31 December 20X1.**

At 31 December 20X1 the SME must, in accordance with paragraph 28.15 of the Standard, recognise a liability (employee benefit: post-employment benefits) of CU20,000 for its defined benefit plan.

Calculation: CU200,000 obligation minus CU180,000 plan assets set aside to fund the defined benefit obligation.

If the SME only looked in Section 2 and applied paragraph 2.126, the SME would present separately the present value of its obligations (liability of CU200,000) and the plan assets (asset of CU180,000). However, paragraph 28.15 overrides the more general requirements of Section 2, as required by paragraph 2.2.

Classification of equity

2.127 To provide useful information, an entity might classify equity claims separately if those equity claims have differing characteristics.

2.128 Similarly, to provide useful information, an entity might classify components of equity separately if some of those components are subject to particular legal, regulatory or other requirements. For example, in some jurisdictions, an entity is permitted to make distributions to holders of equity claims only if it has enough reserves specified as distributable. Separate presentation or disclosure of those reserves might provide useful information.

Educational notes

Section 2 does not address the format of the Statement of Changes in Equity, which is covered in Section 6 *Statement of Changes in Equity and Statement of Income and Retained Earnings*.

Example—Classification of equity

Ex 37 An SME has an equity-settled share-based payment arrangement and applies Section 26 *Share-based Payment* in accounting for this arrangement.

Section 26 requires a charge in profit or loss and does not specify where in equity the corresponding credit entry is recognised.

Aggregation

2.129 Aggregation is the adding together of assets, liabilities, equity, income or expenses that have shared characteristics and are included in the same classification.

2.130 Aggregation can make information more useful by summarising a large volume of detail, but in doing so, aggregation also conceals some of that detail. An entity balances its use of aggregation so that relevant information is not obscured either by too little or too much detail.

Educational notes

The level of aggregation that is most appropriate is determined, in part, by where information is included in the financial statements. Usually, the statement of financial position and statement(s) of financial performance are summarised, whereas the information in the notes is less aggregated, providing more details.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the Standard to transactions or other events or conditions often requires the use of judgement. Information about significant uses of judgement by an entity's management and key sources of estimation uncertainty are useful when assessing an entity's financial position, financial performance and cash flows. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, in accordance with paragraph 8.7, an entity must disclose information that explains key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date that pose a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the Standard require disclosure of information about particular judgements and estimation uncertainties.

In many cases, an entity will not need to engage with the concepts and pervasive principles in Section 2 of the Standard. However, in some cases significant judgement is required (for instance, in particular circumstances, assessments of materiality, economic substance and the assessment of measurement uncertainty and existence uncertainty). Moreover, when the Standard does not specifically address a transaction, other event or condition, management must use its judgement in developing an accounting policy for that transaction or other event or condition which results in information that is reliable and relevant to the economic decision-making needs of users. The second level of the hierarchy established in paragraph 10.5 requires that management look to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles set out in Section 2. Paragraph 2.2 of the Standard states that the requirements of individual sections of the Standard take precedence over the concepts and principles in Section 2.

Materiality assessments

Materiality is defined in paragraph 2.13 of the Standard. Materiality of information depends on the size or nature (or both) of the items to which the information relates, judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factors.

Applying the materiality concept might require significant judgement. When assessing whether information is material to the financial statements, an entity applies judgement to decide whether the information could reasonably be expected to influence decisions that users make on the basis of those financial statements. When applying such judgement, the entity considers both its specific circumstances and how the information provided in the financial statements responds to the information needs of users.

Undue cost or effort

When a specific requirement allows for an undue cost or effort exemption, management must apply its judgement to the entity's specific circumstances. This judgement requires careful consideration of how the economic decisions of users of the financial statements could be affected by not having the information. These considerations might require significant judgement. Entities should not take the undue cost or effort exemption simply because it is available; its application is a matter of careful judgement, and is disclosed as such.

Assessing future economic benefits

When preparing financial statements, an entity's management must assess the degree of uncertainty over whether the future economic benefits associated with an item will flow to or from the entity, and the amount of those economic benefits. Those assessments are made individually for individually significant items, and for a portfolio for a large population of individually insignificant items. Making those estimates might require significant judgement.

TRANSITION REQUIREMENTS

The third edition of the *IFRS for SMEs* Accounting Standard (the Standard) is effective for annual reporting periods beginning on or after 1 January 2027. Early application is permitted. Changes made to Section 2 from the second edition of the Standard are summarised on page 2.

An entity shall retrospectively apply the amendments to Section 2 in accordance with Section 10 *Accounting Policies, Estimates and Errors*. Retrospective application means applying an accounting policy to transactions, other events and conditions as if that policy had always been applied.

COMPARISON WITH FULL IFRS ACCOUNTING STANDARDS

In 2018 the IASB issued the 2018 *Conceptual Framework*, which replaced the 2010-issued *Conceptual Framework*. This revised *Conceptual Framework* is effective for annual reporting periods beginning on or after 1 January 2020, with earlier application permitted.

The main differences between the 2018 *Conceptual Framework* and Section 2 as at February 2025 relate to the paragraph setting out the fact that individual sections take precedence over Section 2, and the undue cost or effort exemption. Other differences are mainly in the level of detail provided.

TEST YOUR KNOWLEDGE

Test your knowledge of the concepts and pervasive principles that underlie the *IFRS for SMEs* Accounting Standard by answering the questions below.

You should assume that all amounts mentioned are material.

Once you have completed the test, check your answers against those supplied on page 65.

Mark the box next to the most correct statement.

Question 1

The objective of general purpose financial statements prepared in accordance with the *IFRS for SMEs* Accounting Standard is:

☐ (a) to support the reporting entity's annual tax return;

☐ (b) to provide the government of the jurisdiction in which the reporting entity operates with financial information for use in government statistics or government planning or both;

☐ (c) to provide management of the reporting entity with the information they need to manage the entity;

☐ (d) to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors when making decisions related to providing resources to the entity.

Question 2

The enhancing qualitative characteristic 'understandability' implies that in preparing financial statements management should:

☐ (a) assume the user has no prior financial reporting knowledge;

☐ (b) simplify areas where the accounting required by the Standard would be difficult to understand;

☐ (c) classify, characterise and present information clearly and concisely;

☐ (d) assume the user is familiar with both the Standard and full IFRS Accounting Standards.

Question 3

Materiality of information depends on:

☐ (a) the magnitude of the item to which the information relates;

☐ (b) the nature of the item to which the information relates;

☐ (c) the nature or magnitude (or both) of the item to which the information relates, judged in the surrounding circumstances.

Question 4

Which of these statements is most accurate about the qualitative characteristic 'faithful representation'?

- ☐ (a) a perfectly faithful representation would be complete, neutral and free from error;
- ☐ (b) faithful representation means the depiction of an economic phenomenon is accurate in all respects;
- ☐ (c) in achieving faithful representation, prudence is more important than neutrality;
- ☐ (d) freedom from error is more important than completeness and neutrality.

Question 5

Which of these would be an acceptable reason for using an 'undue cost or effort' exemption that is specified in the *IFRS for SMEs* Accounting Standard?

- ☐ (a) to measure an item for recognition in the statement of financial position (the entity would have to engage an expert and incur costly fees);
- ☐ (b) to measure an item for disclosure in the financial statements (the entity would have to engage an expert and incur costly fees);
- ☐ (c) to measure an item for recognition in the statement of financial position (the entity would have to engage an expert and incur costly fees that management judges to be substantially greater than the benefits that users of its financial statements would receive).

Question 6

Which of these is **not** an enhancing qualitative characteristic in Section 2?

- ☐ (a) comparability;
- ☐ (b) verifiability;
- ☐ (c) timeliness;
- ☐ (d) reliability.

Question 7

Which of these is **not** part of the definition of an asset in Section 2:

- ☐ (a) a present economic resource;
- ☐ (b) assessed as probable to produce economic benefits;
- ☐ (c) controlled by the entity;
- ☐ (d) a result of past events.

Question 8

Which one of these statements about the recognition and derecognition of assets, liabilities, equity, income and expenses is true:

☐ (a) failure to recognise an item meeting the recognition conditions is acceptable if suitable disclosures are provided instead;

☐ (b) all items that meet the definition of an asset, liability, equity, income or expense must be recognised;

☐ (c) an item can fail to meet the recognition conditions initially but later qualify for recognition;

☐ (d) once an item has been recognised, it can only be derecognised in full, not in part.

Question 9

Which of these satisfies the definition of a liability?

☐ (a) the income-generating capacity of a ski resort is greatly influenced by the amount of snowfall. Snowfall is erratic. To reduce the volatility in its reported profit, the ski resort would like to recognise a liability (and corresponding expense) in years of high snowfall (a provision for warm weather) and release that provision to income in years of low snowfall.

☐ (b) an entity 'self-insures' its assets against loss or damage, that is, it opens a separate bank account (in the company's name) into which it transfers each month an amount equal to the market rate for possible damages or loss. When the entity suffers damage or loss it uses the money in the separate bank account to restore or replace the damaged or lost item. To reduce volatility in its reported profit, the entity would like to recognise a liability (and corresponding expense) in the period in which it transfers cash into the separate bank account (a provision for self-insurance) and decrease that provision when cash is paid out of the separate bank account to replace or restore a damaged or lost item.

☐ (c) an entity has ordered and received services and, at the end of the reporting period, it has not yet paid for these services.

☐ (d) (a), (b) and (c).

☐ (e) none of the above.

Question 10

An entity made an unusually high profit for the year ended 31 December 20X7 because it negotiated a significantly lower cost price for its main raw material at a time when the selling price of its products was rising sharply. Management does not want to make public the unusually high profit because it believes that knowledge of the entity's profitability would result in their customers seeking to negotiate lower selling prices when purchasing goods from the entity. Consequently, management would like to decrease profit for the year by recognising an additional expense for unforeseen possible expenses.

Which of the statements below is correct?

- ☐ (a) because recognising additional expense is prudent, it is acceptable accounting;
- ☐ (b) because recognition of the expense is common practice in the jurisdiction in which the entity operates, it is acceptable accounting;
- ☐ (c) provided the reason for recognising the additional expense is explained in the notes, it is acceptable accounting;
- ☐ (d) because it does not satisfy the definition of an expense, the entity cannot recognise a theoretical possible future expense.

Question 11

The recognition process determines whether to recognise an item. Measurement is the process of determining the monetary amounts at which to measure an item. Choose the statement that is true about uncertainties about the extent of future cash flows:

- ☐ (a) they only affect the decision about whether to recognise an item;
- ☐ (b) they only affect the estimation of the amount at which to measure an item;
- ☐ (c) they could affect decisions about both whether to recognise an item and the measurement of that item.

Answers

Q1 (d)—see paragraph 2.3.

Q2 (c)—see paragraph 2.24.

Q3 (c)—see paragraph 2.13.

Q4 (a)—see paragraph 2.15.

Q5 (c)—see paragraphs 2.28–2.31.

Q6 (d)—see paragraph 2.20.

Q7 (b)—see paragraphs 2.44–2.45.

Q8 (c)—see paragraph 2.68–2.69 and 2.76.

Q9 (c)—see paragraphs 2.49–2.56.

Q10 (d)—see paragraph 2.63.

Q11 (c)—see paragraph 2.72.

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