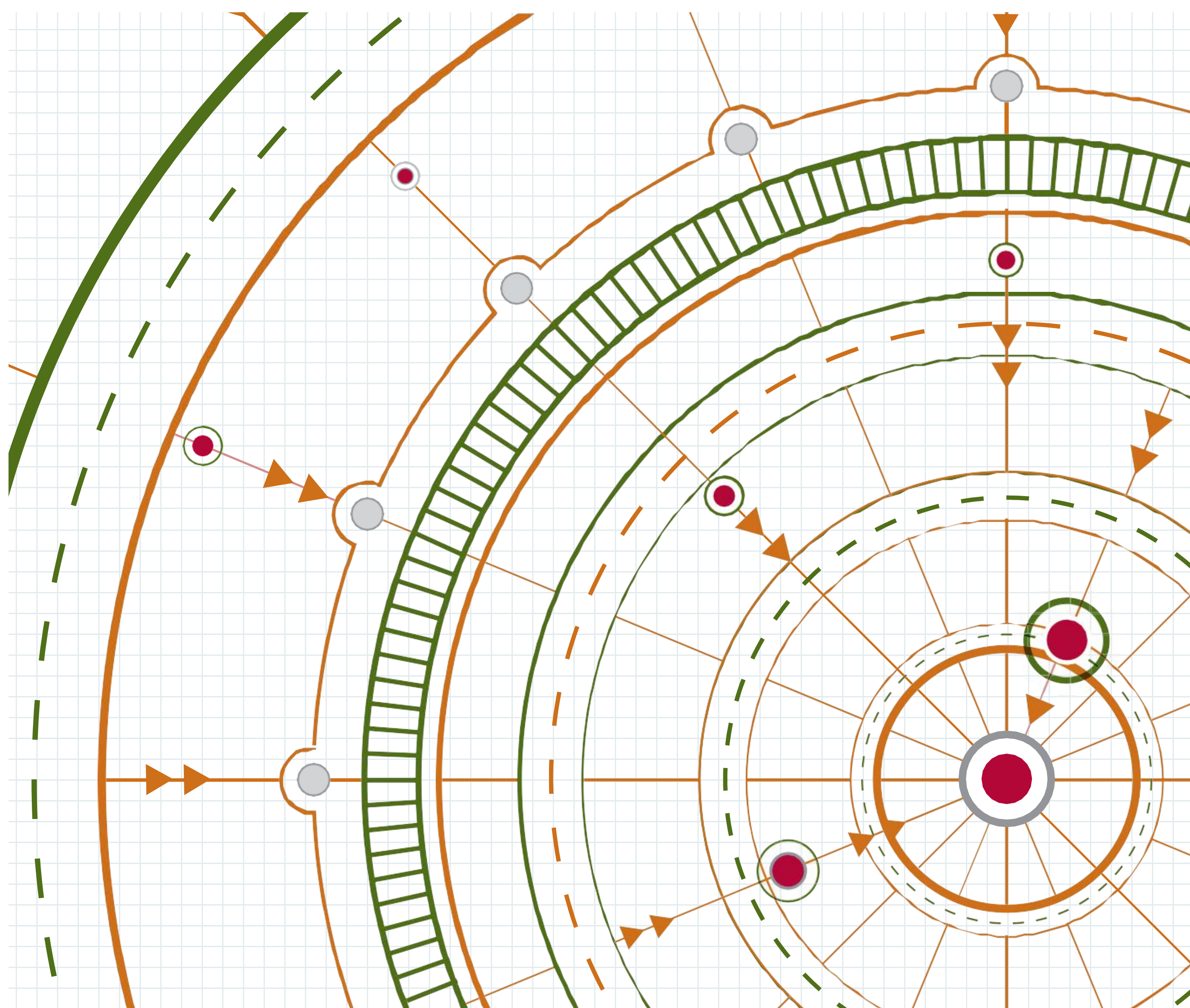
IFRS® Foundation—Supporting Material for the *IFRS for SMEs* Standard

Module 2—Concepts and Pervasive Principles



IFRS®

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

including the full text of
Section 2 *Concepts and Pervasive Principles*
of the *IFRS for SMEs* Standard
issued by the International Accounting Standards Board in October 2015

with extensive explanations, self-assessment questions

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Module 2—Concepts and Pervasive Principles

The accounting requirements applicable to small and medium-sized entities (SMEs) discussed in this module are set out in the *IFRS for SMEs* Standard, issued by the International Accounting Standards Board (Board) in October 2015.
This module has been prepared by IFRS Foundation education staff.
The contents of Section 2 *Concepts and Pervasive Principles* of the *IFRS for SMEs* Standard are set out in this module and shaded grey. The Glossary of terms of the *IFRS for SMEs* Standard (Glossary) 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. The notes and examples inserted by the education staff are not shaded. These notes and examples do not form part of the *IFRS for SMEs* Standard and have not been approved by the Board.

INTRODUCTION

Which version of the *IFRS for SMEs*® Standard?

When the *IFRS for SMEs* Standard was first issued in July 2009, the Board said it would undertake an initial comprehensive review of the Standard to assess entities' experience of the first two years of its application and to consider the need for any amendments. To this end, in June 2012, the Board issued a Request for Information: *Comprehensive Review of the IFRS for SMEs*. An Exposure Draft proposing amendments to the *IFRS for SMEs* Standard was subsequently published in 2013, and in May 2015 the Board issued *2015 Amendments to the IFRS for SMEs* Standard.

The document published in May 2015 only included amended text, but in October 2015, the Board issued a fully revised edition of the Standard, which incorporated additional minor editorial amendments as well as the substantive May 2015 revisions. This module is based on that version.

The *IFRS for SMEs* Standard issued in October 2015 is effective for annual periods beginning on or after 1 January 2017. Earlier application was permitted, but an entity that did so was required to disclose the fact.

Any reference in this module to the *IFRS for SMEs* Standard refers to the version issued in October 2015.

This module

This module focuses on the concepts that underlie financial statements prepared in accordance with the *IFRS for SMEs* Standard. The concepts in Section 2 are based on the Board's *Framework for the Preparation and Presentation of Financial Statements* (published in 1989). This framework was revised and renamed the *Conceptual Framework for Financial Reporting (Conceptual Framework)* in 2010 and revised again in 2018. Some notes presented in this module are derived from the Basis for Conclusions on the *Conceptual Framework*, and, unless specifically stated otherwise, come from the 2018 version. References to the *Conceptual Framework* are not meant to imply that the users of the *IFRS for SMEs* Standard should be familiar with the *Conceptual Framework*. The references also do not indicate an intention to change the meaning or application of Section 2 to reflect revisions to the *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 *IFRS for SMEs* Standard. In addition, the module includes questions designed to test your understanding of the concepts and pervasive principles underpinning the *IFRS for SMEs* Standard.

Upon successful completion of this module, you should, within the context of the *IFRS for SMEs* Standard, be able to:

- understand the objective of general purpose financial statements of a small or medium-sized entity;
- use your 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 of the financial statements;
- understand 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.

IFRS for SMEs Standard

The *IFRS for SMEs* Standard is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* Standard is comprised of mandatory requirements and other non-mandatory material.

The non-mandatory material includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* Standard and explains its purpose, structure and authority;
- implementation guidance, which includes illustrative financial statements and a table of presentation and disclosure requirements;
- the Basis for Conclusions, which summarises the Board's main considerations in reaching its conclusions in the *IFRS for SMEs* Standard issued in 2009 and, separately, in the 2015 Amendments; and
- the dissenting opinion of a Board member who did not agree with the issue of the *IFRS for SMEs* Standard in 2009 and the dissenting opinion of a Board member who did not agree with the 2015 Amendments.

In the *IFRS for SMEs* Standard, Appendix A: Effective date and transition, and Appendix B: Glossary of terms, are part of the mandatory requirements.

In the *IFRS for SMEs* Standard, there are appendices to Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue.* These appendices provide non-mandatory guidance.

Module 2—Concepts and Pervasive Principles

The *IFRS for SMEs* Standard has been issued in two parts: Part A contains the preface, all the mandatory material and the appendices to Section 21, Section 22 and Section 23; and Part B contains the remainder of the material mentioned above.

Further, the SME Implementation Group (SMEIG), which assists the Board with supporting implementation of the *IFRS for SMEs* Standard, publishes implementation guidance as 'questions and answers' (Q&As). These Q&As provide non-mandatory, timely guidance on specific accounting questions raised with the SMEIG by entities implementing the *IFRS for SMEs* Standard and other interested parties. At the time of issue of this module (January 2019) the SMEIG has not issued any Q&As relevant to this module.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the entity's financial position, performance and cash flows that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs. Such users include, for example, owners who are not involved in managing the business, existing and potential creditors and credit rating agencies.

The purpose of the concepts and pervasive principles are primarily to:

(a) assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction; and

(b) assist all parties to understand and interpret the *IFRS for SMEs* Standard.

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

When the *IFRS for SMEs* 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 *IFRS for SMEs* Standard setting out similar and related issues, then it must consider the pervasive principles in Section 2 (see paragraphs 10.4 and 10.5) as well as considering definitions of the elements of the financial statements, recognition criteria and measurement concepts.

What has changed since the 2009 IFRS for SMEs Standard?

The main change made to Section 2 of the *IFRS for SMEs* Standard by the 2015 Amendments is the addition of clarifying guidance on the undue cost or effort exemption used in several sections of the *IFRS for SMEs* Standard—based on Q&A 2012/01 *Application of 'undue cost or effort'*—as well as a new requirement within relevant sections for entities to disclose their reasoning for using such an exemption (see paragraphs 2.14A−2.14D).

There are also minor consequential changes to other paragraphs to reflect changes made to other sections of the *IFRS for SMEs Standard*. In addition, this module reproduces other editorial changes.

Module 2—Concepts and Pervasive Principles

REQUIREMENTS AND EXAMPLES

Scope of this section

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

Notes

Financial reports mainly are based on estimates, judgements and models rather than on exact depictions. Section 2 of the *IFRS for SMEs* Standard reflects the 1989 Framework's definitions of the concepts that underlie those estimates, judgements and models. By articulating the objectives of financial statements for SMEs, the qualities that make the information useful and the underlying principles and concepts Section 2 serves two important functions. It:

(a) assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction or other event, or when a Standard allows a choice of accounting policy; and

(b) assists all parties to understand and interpret the *IFRS for SMEs* Standards.

Objective of financial statements of small and medium-sized entities

2.2 The objective of financial statements of a small or medium-sized entity is to provide information about the **financial position**, **performance** and **cash flows** of the entity that is useful for economic decision-making by a broad range of users of the financial statements who are not in a position to demand reports tailored to meet their particular information needs.

Notes

The objective of general purpose financial statements is to provide financial information about the reporting entity that is useful for economic decision-making by a broad range of users of the financial statements who are not in a position to demand reports tailored to meet their information needs. Section 2 does not explicitly identify a group of primary users. Paragraph BC80 of the Basis for Conclusions on the *IFRS for SMEs* 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.

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

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

Each of these groups will have different decisions to make regarding an SME. However, often at the heart of these decisions are an assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and management's stewardship of the entity's economic resources.

To make these assessments external users need information about (*Conceptual Framework* paragraph 1.4):

(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 and governing board have discharged their responsibilities to use the entity'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 financial statements of SMEs may have less interest in some information in general purpose financial statements prepared in accordance with full IFRS Standards. For example, users of financial statements of SMEs may have greater interest in short-term cash flows, liquidity, strength of the statement of financial position and interest coverage, and in the historical trends of profit or loss and interest coverage, than they do in information that is intended to assist in making forecasts of an entity's long-term cash flows, profit or loss, and equity value.

External users of financial reports prepared based on full IFRS Standards or *the IFRS for SMEs* Standard have similar objectives, irrespective of the type of entities. In developing the *IFRS for SMEs* Standard, by making simplifications to full IFRS Standards, the Board 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, suggested that a separate standard for SMEs is appropriate.

General purpose financial reports do not and cannot provide all of the information that users (eg owners who are not involved in managing the business, existing and potential creditors and credit rating agencies) need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.

2.3 Financial statements also show the results of the stewardship of management—the accountability of management for the resources entrusted to it.

Notes

Users make resource allocation decisions as well as decisions as to how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources. That assessment enables 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

Notes

The qualitative characteristics of information in financial statements identify the characteristics of information that is useful to users for making decisions about the reporting entity.

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

Understandability

2.4 The information provided in financial statements should be presented in a way that makes it comprehensible by users who have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, the need for **understandability** does not allow relevant information to be omitted on the grounds that it may be too difficult for some users to understand.

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. Users are responsible for studying reported financial information with reasonable diligence. In addition, users may need to seek the aid of advisers to understand economic phenomena that are particularly complex.

Examples—understandability

Ex 1 **An entity 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 entity cannot claim compliance with the *IFRS for SMEs* 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 2 **An entity has investment property. Under tax legislation in that 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 and effort exemption in this chapter and does not account for the fair value of the property.**

The entity cannot claim compliance with the IFRS for SMEs Standard if it chooses not to account for the investment property at fair value in accordance with Section 16 Investment Property on the grounds that management believes the users of its financial statements would not understand that financial information.

Relevance

2.5 The information provided in financial statements must be relevant to the decision-making needs of users. Information has the quality of **relevance** when it is capable of influencing the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

Notes

It is self-evident that financial information is useful for decision-making only if it is capable of influencing a decision. Relevance is the term used to describe that capability. Many decisions by owners, potential owners, 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), or 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 all entities in a jurisdiction may not be relevant. This also includes policy statements that are irrelevant to understanding the entity’s financial statements. An example may be a statement about the methods and significant assumptions applied when estimating the fair value of property, plant and equipment accounted for under the revaluation method (Section 17 *Property, Plant and Equipment* paragraph 17.33(c)) when no items are carried at revalued amounts.

Materiality

2.6 Information is **material**—and therefore has relevance—if its omission or misstatement could influence the economic decisions of users made on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. However, it is inappropriate to make, or leave uncorrected, immaterial departures from the *IFRS for SMEs* to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

Notes

Materiality is an aspect of relevance, because immaterial information does not affect a user's decision. 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 (see paragraph 2.4). Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of such users made on the basis of the financial statements.

Materiality is based on the nature, or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a given situation.

An entity need not provide a specific disclosure required by the *IFRS for SMEs* Standard if the information is not material. Moreover, an entity need not apply its accounting policies when the effect of not applying them is immaterial (see paragraph 10.3).

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 form 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 may warrant separate presentation in the notes.

Examples—immaterial items

Ex 3 **In 20X9, after the entity's 20X8 financial statements were approved for issue, the entity discovered an error in the calculation of depreciation expense for the year ended 31 December 20X8. The error meant the entity's reported profit before tax for the year ended 31 December 20X8 of CU600,000[1] was understated by CU150 .**

The error is probably not material—it is highly unlikely that an error of this magnitude could influence the economic decisions of users made on the basis of the financial statements. Hence, the entity may choose not to follow the requirements for corrections to prior period errors set out in paragraph 10.21.

Examples—material items

Ex 4 **The facts are the same as in Example 3. However, in this example, if the error had been corrected the entity would have breached a borrowing covenant on a significant long-term liability.**

The error is material—it could influence the economic decisions of users made on the basis of the financial statements.

Ex 5 **In 20X9, before the entity's 20X8 financial statements were approved for issue, the entity 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 entity at the beginning of 20X8 is an overstatement of CU600,000. The entity reported total equity of CU950,000 at 31 December 20X7.**

The error is material—it could influence the economic decisions of users made on the basis of the financial statements.

In all examples above (examples 3 to 5), the entity's management assesses whether the size and nature of the omission or misstatement judged in surrounding circumstances is material.

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

Reliability

2.7 The information provided in financial statements must be reliable. Information is reliable when it is free from material **error** and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent. Financial statements are not free from bias (ie not neutral) if, by the selection or presentation of information, they are intended to influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Notes

Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must be reliable and so also faithfully represent the phenomena that it purports to represent.

Faithful representation does not mean 'accurate in all respects'. Free from error 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 one without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, deemphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users.

Substance over form

2.8 Transactions and other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form. This enhances the **reliability** of financial statements.

Note

Representation on the basis of a legal form that differs from the economic substance of the underlying economic phenomenon could result in a representation that is not faithful. The legal form should generally be considered as pervasive evidence of the economic substance of an underlying phenomenon. However, there are many circumstances in which this is not the case. For some such phenomenon, an entity may need to perform an in-depth review of facts and circumstances in arriving at a judgment that overrides the legal form. In others, the practice is well understood and regularly applied.

Examples—substance over form

Ex 6 **A luxury yacht manufacturer 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 taken together is that the manufacturer has borrowed CU1,000,000 from the bank and that borrowing 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 asset.

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 loan using the effective interest method.

Ex 7 **The facts are the same as in example 6. However, in this example, the manufacturer 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 manufacturer is most unlikely to let the option lapse. Consequently, the substance of the two transactions taken together is still that the manufacturer has borrowed CU1,000,000 from the bank and that borrowing 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 asset.

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 loan using the effective interest method.

Prudence

2.9 The uncertainties that inevitably surround many events and circumstances are acknowledged by the disclosure of their nature and extent and by the exercise of **prudence** in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that **assets** or **income** are not overstated and **liabilities** or **expenses** are not understated. However, the exercise of prudence does not allow the deliberate understatement of assets or income or the deliberate overstatement of liabilities or expenses. In short, prudence does not permit bias.

Notes

Prudence is the exercise of caution when making 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, the exercise of 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, management cannot use the concept of prudence to deliberately reflect conservative estimates of assets, liabilities or income.

Completeness

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

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 may 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.

Comparability

2.11 Users must be able to compare the financial statements of an entity through time to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities to evaluate their relative financial position, performance and cash flows. Hence, the **measurement** and display of the financial effects of like transactions and other events and conditions must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way across entities. In addition, users must be informed of the **accounting policies** employed in the preparation of the financial statements and of any changes in those policies and the effects of such changes.

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 in the preparation of 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.

Timeliness

2.12 To be relevant, financial information must be able to influence the economic decisions of users. **Timeliness** involves providing the information within the decision time frame. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the needs of users in making economic decisions.

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 may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

Balance between benefit and cost

2.13 The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is substantially a judgemental process. Furthermore, the costs are not necessarily borne by those who enjoy the benefits, and often the benefits of the information are enjoyed by a broad range of external users.

2.14 Financial reporting information helps capital providers make better decisions, which results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. Individual entities also enjoy benefits, including improved access to capital markets, favourable effect on public relations and perhaps lower costs of capital. The benefits may also include better management decisions because financial information used internally is often based at least partly on information prepared for general purpose financial reporting purposes.

Notes

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

The Board considers costs from a number of perspectives. Providers of financial information expend effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur the costs of analysing and interpreting the information provided. If information that users need is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.

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 reports to provide all the information that every user finds relevant.

In developing the *IFRS for SMEs* Standard the Board made simplifications from full IFRS Standards on the basis of users' needs and on cost-benefit analyses. In practice, the benefits of applying accounting standards differ across reporting entities, depending primarily on the nature, number and information needs of the users of their financial statements. Application of the cost constraint can result in requirements in the Standard that do not maximise the qualitative characteristics or other main concepts in Section 2. To maintain a cohesive understanding of the *IFRS for SMEs* Standard, it is helpful to understand why the Board concluded that for some requirements it was cost-beneficial not to maximise the qualitative characteristics. Its reasons are usually set out in the basis for conclusions that accompanies, but does not form part of the *IFRS for SMEs* Standard.

Undue cost or effort

2.14A An undue cost or effort exemption is specified for some requirements in this Standard. This exemption shall not be used for other requirements in this Standard.

2.14B Considering whether obtaining or determining the information necessary to comply with a requirement would involve undue cost or effort depends on the entity's specific circumstances and on management's judgement of the costs and benefits from applying that requirement. This judgement requires consideration of how the economic decisions of those that are expected to use the financial statements could be affected by not having that information. Applying a requirement would involve undue cost or effort by an SME if the incremental cost (for example, valuers' fees) or additional effort (for example, endeavours by employees) substantially exceed the benefits that those that are expected to use the SME's financial statements would receive from having the information. An assessment of undue cost or effort by an SME in accordance with this Standard would usually constitute a lower hurdle than an assessment of undue cost or effort by a publicly accountable entity because SMEs are not accountable to public stakeholders.

2.14C Assessing whether a requirement would involve undue cost or effort on initial **recognition** in the financial statements, for example at the date of the transaction, should be 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 subsequent to initial recognition, for example to a subsequent measurement of an item, a new assessment of undue cost or effort should be made at that subsequent date, based on information available at that date.

2.14D Except for the undue cost or effort exemption in paragraph 19.15, which is covered by the disclosure requirements in paragraph 19.25, whenever an undue cost or effort exemption is used by an entity, the entity shall disclose that fact and the reasons why applying the requirement would involve undue cost or effort.

Notes

Some exemptions from requirements in the *IFRS for SMEs* Standard are effective when it would be impracticable to comply with the 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 when reclassification might be impracticable could be when a fire 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.

While not being a low 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 as required in a Section or disclosing a piece of information 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 may 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.

The application of an undue cost or effort exemption necessitates consideration of how those expected users of the financial statements would be affected if that exemption is taken. Consequently, it may 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 and SMEs are not accountable to public stakeholders. .

An entity must make a new assessment of whether a requirement will involve undue cost or effort at each reporting date.

Paragraphs 2.13 and 2.14 of the *IFRS for SMEs* Standard highlight the balance between benefits and costs and state the general principle to which the Board refers in making its standard-setting decisions. Hence, the requirements within the *IFRS for SMEs* Standard have been developed by taking into consideration the balance between benefits and costs. In addition, the *IFRS for SMEs* Standard allows an undue cost or effort exemption in certain defined circumstances; the undue cost or effort exemption cannot be applied throughout the Standard. The exemption can only be used if the *IFRS for SMEs* Standard explicitly specifies that it can be applied to a requirement.

Elements

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. 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 most useful to users for the purpose of making economic decisions (see paragraph 5.11) whereas current and non-current assets and current and non-current liabilities 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).

Financial position

2.15 The financial position of an entity is the relationship of its assets, liabilities and **equity** as of a specific date as presented in the **statement of financial position**. These are defined as follows:

(a) an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity;

(b) a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits; and

(c) equity is the residual interest in the assets of the entity after deducting all its liabilities.

Notes

General purpose financial statements provide information about the financial position of a reporting entity, which is information about the entity's economic resources (assets) and the claims against the reporting entity (liabilities and equity). Financial statements also 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. 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 prospects for 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 reports need to know the nature and amount of the resources available for use in a reporting entity's operations.

2.16 Some items that meet the definition of an asset or a liability may not be recognised as assets or liabilities in the statement of financial position because they do not satisfy the criteria for recognition in paragraphs 2.27–2.32. In particular, the expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion before an asset or liability is recognised.

Notes

Paragraphs 18.14 and 18.15 specifically prohibit the recognition of certain intangible assets such as brands, mastheads, publishing titles, customer lists and items similar in substance that are internally generated, because internally generated intangible items of this type would rarely, and perhaps never, meet the recognition criteria.

Section 18 *Intangible Assets other than Goodwill* also clarifies that expenditure on research, training, advertising and start-up activities does not result in the creation of an intangible asset that can be recognised in the financial statements. Some view this interpretation of the application of the recognition criteria as being too restrictive and arbitrary. The prohibition also reflects the fact that it is sometimes difficult to determine whether there is an internally generated intangible asset distinguishable from internally generated goodwill.

Assets

2.17 The future economic benefit of an asset is its potential to contribute, directly or indirectly, to the flow of **cash** and **cash equivalents** to the entity. Those cash flows may come from using the asset or from disposing of it.

Notes

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 asset;

(b) exchange assets 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 assets to produce goods or provide services;
- (ii) using the asset to enhance the value of other assets; or
- (iii) leasing the asset to another party;

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

(e) extinguish liabilities by transferring the asset.

2.18 Many assets, for example **property, plant and equipment**, have a physical form. However, physical form is not essential to the existence of an asset. Some assets are intangible.

Notes

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

Example—cash

Ex 8 **An entity has cash.**

The cash is an asset of the entity—the entity determines the purpose to which the cash is put and thereby expects to generate cash inflows (ie cash renders a service to the entity because of its command over other resources).

Examples—assets with physical form

Ex 9 **An entity owns a machine that manufactures its products.**

The machine is a physical asset used in the production of goods that are expected to generate cash inflows from their sale.

Ex 10 **An entity owns a factory building in which it manufactures its products.**

The building is a physical asset used in the production of goods that are expected to generate cash inflows from their sale.

Ex 11 **An entity owns a fleet of motor vehicles. The vehicles are used by the sales staff in the performance of their duties.**

The motor vehicles are physical assets used in the supply of goods. The entity expects to recover the carrying amount of the vehicles out of cash inflows generated from the sale of goods.

Ex 12 **An entity 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 entity. The entity expects to recover the carrying amount of the vehicle out of cash inflows generated from the sale of goods.

Ex 13 **An entity 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 entity expects to generate cash inflows from the sale of the calves.

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

The building is a physical asset used by the entity to earn lease rentals. The entity expects to recover the carrying amount of the building out of the rental cash inflows that it generates.

Examples—assets without physical form

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

The brand name (a trademark) is an intangible asset of the entity. It is an asset of the entity—control is evidenced by the legal right and the entity would have purchased the brand name with the expectation that the brand would increase the entity's future revenues either by selling products or by preventing its competitors from selling products (future economic benefits). The asset (brand name) is an intangible asset—it is without physical substance (it is a legal right).

Ex 16 **An entity operates 20 taxis under licence in city A. The taxi licences are transferable to other qualified taxi operators.**

The taxi licences are intangible assets of the entity. The licences are assets of the entity because the entity has control through the legal right to operate 20 taxis in the city to generate future economic benefits from taxi fares. The assets (taxi licences) are without physical substance (they are legal rights).

Ex 17 **Entity 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 Entity A—Entity A has control over the shares (eg it decides whether to hold or sell them). Entity A would expect future economic benefits to flow from its holding of shares in B. This 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 relationship with B.

2.19 In determining the existence of an asset, the right of ownership is not essential. Thus, for example, property held on a **lease** is an asset if the entity controls the benefits that are expected to flow from the property.

Notes

Refer to Module 20 for more detailed discussion on leases.

Liabilities

2.20 An essential characteristic of a liability is that the entity has a present obligation to act or perform in a particular way. The obligation may be either a legal obligation or a **constructive obligation**. A legal obligation is legally enforceable as a consequence of a binding contract or statutory requirement. A constructive obligation is an obligation that derives from an entity's actions when:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Notes

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 created a valid expectation on the part of those other parties that it will discharge those responsibilities. The obligation that arises in such situations is referred to as a 'constructive obligation'.

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. Such reserves are sometimes referred to as provisions. These reserves do not meet the definition of a liability in the *IFRS for SMEs* Standard as there is no present obligation to act or perform in a certain way. Consequently, recognition as liabilities of such 'general reserves' is prohibited.

Similarly, 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 may be an indicator that some of the entity's assets are impaired. Recognition of impairment losses is covered by Section 27 *Impairment of Assets*. In addition, if an entity has entered into an onerous contract (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—entering into a binding contract.

Examples—liabilities

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

The debt instrument (trade payable) is a financial liability of Entity A—the purchase of the goods on credit created a contractual obligation (a legal obligation) for Entity A to pay (expected cash outflow) Entity B.

Ex 19 **Waste from an entity's production process contaminated the groundwater at the entity's plant. The entity is required by law to restore the contaminated environment.**

The entity has a liability—at the end of the reporting period it has an obligation by law to restore the damage caused to the environment (ie the obligating event). Restoring the environment is expected to result in cash outflows.

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

Although the pledge may not be legally enforceable, by participating in the press conference and by allowing its name to be used in the solicitation, the entity has indicated that it has accepted an obligation to honour its pledge and has created a valid expectation on the part of the arts centre that it will do so (ie its actions have given rise to a constructive obligation).

The entity has a liability—it has a constructive obligation (ie because of its actions the entity has no realistic alternative but to contribute the substantial sum of money toward the construction of the new performing arts centre).

Examples—not liabilities—no obligating event

Ex 21 **An entity that operates 10 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 entity can estimate reliably the statistical probability of the occurrence and amount of expected fire loss (loss of about CU100,000 once every ten years). The entity wants to recognise a liability of CU10,000 and related expense each year for the next ten years to reflect its expected loss. The entity reasons that the loss is highly probable, the amount can be measured reliably, and if it had purchased insurance, it would recognise an expense in each reporting period.**

The fact that the entity bears the risk of fire does not create an obligation that is recognised as a liability. An entity that purchases insurance has paid to transfer its risk to a third party, and on the date that it is made, that payment is properly recognised as an asset (prepayment for services) and is then recognised as an expense in profit or loss over the period in which the insurance coverage is consumed, regardless of whether there's a fire loss.

A fire at one of the stations would be an event that triggers an impairment test on the fire damaged asset. The impairment test might result in the recognition of an impairment loss in profit or loss.

Ex 22 **A ski resort operator 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 entity believe that, because of the 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 entity's management and owners 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 entity has no obligation to act or perform in a certain way in expectation of a bad year. It is not appropriate to recognise a provision under the *IFRS for SMEs* Standard because the definition of a liability is not met.

An accrual that is allowed for local income tax purposes is not the same as an expense or liability to be recognised for financial reporting purposes. These items may result in a deferred tax asset or liability (see Section 29 *Income Taxes*).

2.21 The settlement of a present obligation usually involves the payment of cash, the transfer of other assets, the provision of services, the replacement of that obligation with another obligation or the conversion of the obligation to equity. An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

Equity

2.22 Equity is the residual of recognised assets minus recognised liabilities. It may be subclassified in the statement of financial position. For example, in a corporate entity, subclassifications may include funds contributed by shareholders, retained earnings and items of **other comprehensive income** recognised as a separate component of equity. This Standard does not prescribe how, when or if amounts can be transferred between components of equity.

Examples—equity

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

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

Ex 24 **On 31 December 20X0 Entity 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 the CU25,000 non-controlling interest in the net assets of a subsidiary. Non-controlling interests are the residual interest held by parties other than Entity A in the net assets of those subsidiaries.

Consequently, it meets the definition of equity (ie the residual interest in the assets of the entity after deducting its liabilities).

Note: a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. An essential characteristic of a liability is that the entity has a present obligation and that an obligation is a duty or responsibility to act or perform in a particular way. The NCI holders are typically in the same position as other shareholders, and the entity therefore has no present obligation to pay. This would not however always be the case (for example if the NCI have the right to put their shares to the entity). .

Ex 25 **Since its formation, 75% of a subsidiary has been owned by the reporting entity (parent) and 25% by an independent third party. In the current reporting period when the subsidiary's equity was CU100,000 (ie 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 (ie 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 (eg retained earnings) by CU35,000 (ie a reallocation within equity).

Ex 26 **On the retirement of one of the owner-managers of an entity on 31 December 20X0, the entity repurchased the shares held by the retiree for their fair value CU1,000.**

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

Note: the entity's own shares are not an asset of the entity. Instead, the shares are an interest in the entity's assets. Consequently, the own shares acquired are not recognised as an asset because they lack the essential feature of an asset—the ability to provide future economic benefits. The future economic benefits usually provided by an interest in shares are dividends and an increase in the value of the shares. When a company 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 company, because there is no change in net assets: the flow of funds is simply circular. **The facts are the same as in Example 29. However, in this example, on 1 January 20X2 the entity issued the shares to a previously independent third party who simultaneously became an owner-manager of the entity in exchange for CU1,200 (the then fair value of the shares).**

The entity's own shares, while held by the entity, 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 issue of those shares.

Performance

2.23 Performance is the relationship of the income and expenses of an entity during a **reporting period**. This Standard permits entities to present performance in a single financial statement (a **statement of comprehensive income**) or in two financial statements (an **income statement** and a statement of comprehensive income). **Total comprehensive income** and **profit or loss** are frequently used as measures of performance or as the basis for other measures, such as return on investment or earnings per share. Income and expenses are defined as follows:

(a) income is increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from **owners**; and

(b) expenses are decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to owners.

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.

Income and expenses are the elements of financial statements that relate to an entity's financial performance. Users of financial statements need information about both an entity's financial position and its financial performance. Hence, 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.

Financial performance is measured as the net of all income and expenses for the period (total comprehensive income), which are 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 *IFRS for SMEs* 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.

2.24 The recognition of income and expenses results directly from the recognition and measurement of assets and liabilities. Criteria for the recognition of income and expenses are discussed in paragraphs 2.27–2.32.

Notes

Information about a reporting entity's financial performance during a period, reflected by changes in its economic resources and claims, other than by obtaining additional resources directly from investors and creditors, is useful in assessing the entity's past and future ability to generate net cash inflows. That information

indicates the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations, rather than by obtaining additional resources directly from investors and creditors. Information about a reporting entity's financial performance during a period can also help users to assess management's stewardship of the entity's economic resources.

Information about a reporting entity's financial performance during a period may 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.

Income

2.25 The definition of income encompasses both **revenue** and **gains**:

(a) revenue is income that arises in the course of the ordinary activities of an entity and is referred to by a variety of names including sales, fees, interest, dividends, royalties and rent.

(b) gains are other items that meet the definition of income but are not revenue. When gains are recognised in the statement of comprehensive income, they are usually displayed separately because knowledge of them is useful for making economic decisions.

Examples—revenue or gain?

Ex 27 **On 31 December 20X5 an entity sold inventory for CU1,500 when the carrying amount of the inventory was CU1,000.**

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

Ex 28 **On 31 December 20X5 an entity sold a machine used by the entity in the manufacture of goods for CU1,500 when the carrying amount of the machine was CU1,000.**

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

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

Expenses

2.26 The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity:

(a) expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and **depreciation**. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, **inventory** or property, plant and equipment.

(b) **losses** are other items that meet the definition of expenses and may arise in the course of the ordinary activities of the entity. When losses are recognised in the statement of comprehensive income, they are usually presented separately because knowledge of them is useful for making economic decisions.

Examples—expense or loss?

Ex 29 **On 31 December 20X5 an entity sold inventory for CU1,000 when the carrying amount of the inventory was CU900.**

On 31 December 20X5 the entity recognises CU1,000 income (revenue from the sale of goods) and CU900 *expense* (costs of goods sold)

Ex 30 **On 31 December 20X5 an entity sold a machine used by the entity in the manufacture of goods for CU900 when the carrying amount of the machine was CU1,000.**

On 31 December 20X5 the entity 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 less CU1,000 carrying amount derecognised on sale equals CU100 loss on disposal of machine. The loss is a net amount.

Recognition of assets, liabilities, income and expenses

2.27 Recognition is the process of incorporating in the financial statements an item that meets the definition of an asset, liability, income or expense and satisfies the following criteria:

(a) it is **probable** that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured reliably.

2.28 The failure to recognise an item that satisfies those criteria is not rectified by disclosure of the accounting policies used or by **notes** or explanatory material.

The probability of future economic benefit

2.29 The concept of probability is used in the first recognition criterion to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence relating to conditions at the end of the reporting period available when the financial statements are prepared. Those assessments are made individually for individually significant items, and for a group for a large population of individually insignificant items.

Notes

Some requirements in the *IFRS for SMEs* Standard give effect to this concept of probability by requiring recognition of an item that meets the definition of an element only if it is more likely than not that the future economic benefits associated with the item will flow to or from the entity (eg in determining whether a liability is recognised for a particular present obligation). In such cases, the outcome is binary—if the probability of the outflow is greater than 50% a liability is recognised (conversely, if the probability of the outflow is 50% or less, the obligation is not recognised as a liability— it is excluded from the entity's statement of financial position).

Other requirements require recognition of elements that meet the definition of an element (eg asset or liability) and reflect the uncertainties associated with the likelihood of cash flows from rights or obligations in the measurement of that asset or liability—for example, when measuring an item at fair value.

Reliability of measurement

2.30 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability. In many cases, the cost or value of an item is known. In other cases it must be estimated. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When a reasonable estimate cannot be made, the item is not recognised in the financial statements.

2.31 An item that fails to meet the recognition criteria may qualify for recognition at a later date as a result of subsequent circumstances or events.

2.32 An item that fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes or explanatory material or in supplementary schedules. This is appropriate when knowledge of the item is relevant to the evaluation of the financial position, performance and changes in financial position of an entity by the users of financial statements.

Notes

For example, in Section 21, the recognition criterion for a liability (provision) of a present obligation is satisfied only when the probability of the outflow is greater than 50%. In accounting for a present obligation under Section 21, if the probability of the outflow is 50% or less, the present obligation is not recognised as a liability (ie the 'contingent' liability is excluded from the entity's statement of financial position). However, unless the possibility of the outflow of resources is remote, the contingent liability is disclosed in the notes (see paragraph 21.12).

Measurement of assets, liabilities, income and expenses

2.33 Measurement is the process of determining the monetary amounts at which an entity measures assets, liabilities, income and expenses in its financial statements. Measurement involves the selection of a basis of measurement. This Standard IFRS specifies which measurement basis an entity shall use for many types of assets, liabilities, income and expenses.

Notes

Elements recognised in financial statements are quantified in monetary terms. This requires the selection of a measurement basis. A measurement basis is an identified feature—for example, historical cost or fair value—of an 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.

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.

2.34 Two common measurement bases are historical cost and **fair value**:

(a) for assets, historical cost is the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire the asset at the time of its acquisition. For liabilities, historical cost is the amount of proceeds of cash or cash equivalents received or the fair value of non-cash assets received in exchange for the obligation at the time the obligation is incurred, or in some circumstances (for example, **income tax**) the amounts of cash or cash equivalents expected to be paid to settle the liability in the normal course of business. Amortised historical cost is the historical cost of an asset or liability plus or minus that portion of its historical cost previously recognised as expense or income.

(b) fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. In situations in which fair value measurement is permitted or required, the guidance in paragraphs 11.27–11.32 shall be applied.

Notes

Other measurement methods required or permitted for assets and liabilities in the *IFRS for SMEs* Standard include the equity method for investments in associates, 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.

Paragraphs 11.27–11.32 provide guidance on how to measure the fair value of financial instruments. That guidance is also useful for measuring the fair value of other assets and liabilities.

Pervasive recognition and measurement principles

2.35 The requirements for recognising and measuring assets, liabilities, income and expenses in this Standard are based on pervasive principles that are derived from **full IFRS**. In the absence of a requirement in this Standard that applies specifically to a transaction or other event or condition, paragraph 10.4 provides guidance for making a judgement and paragraph 10.5 establishes a hierarchy for an entity to follow in deciding on the appropriate accounting policy in the circumstances. The second level of that hierarchy requires an entity to look to the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and the pervasive principles set out in this section.

Notes

In accordance with paragraph 10.4, when the *IFRS for SMEs* 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 considers the requirements and guidance in the *IFRS for SMEs* Standard on similar and related issues. Next, the entity considers definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses and as well as considering the pervasive principles in Section 2. If the Standard does not provide guidance, the entity may look to the requirements and guidance in full IFRS Standards, including Interpretations of full IFRS Standards, dealing with similar and related issues.

Accrual basis

2.36 An entity shall prepare its financial statements, except for cash flow information, using the **accrual basis of accounting**. On the accrual basis, items are recognised as assets, liabilities, equity, income or expenses when they satisfy the definitions and recognition criteria for those items.

Notes

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources (assets) and claims (liabilities) in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. Accrual accounting is important because information about a reporting entity's economic resources and claims and about changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than does information solely about cash receipts and payments during that period.

Information about a reporting entity's financial performance during a period, reflected by changes in its economic resources and claims other than by obtaining additional resources directly from investors or creditors, is useful in assessing the entity's past and future ability to generate net cash inflows. That information indicates the extent to which the reporting entity has increased its available economic resources and thus its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors. Information about a reporting entity's financial performance during a period can also help users to assess management's stewardship of the entity's economic resources.

Recognition in financial statements

Assets

2.37 An entity shall recognise an asset in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably. An asset is not recognised in the statement of financial position when expenditure has been incurred for which it is considered not probable that economic benefits will flow to the entity beyond the current reporting period. Instead such a transaction results in the recognition of an expense in the statement of comprehensive income (or in the income statement, if presented).

Examples—recognition of assets

Ex 31 **An entity has developed a formula it uses to manufacture a unique glue. The glue is the leading adhesive product in the market because of its distinctive mix of chemicals. The special formula is known only by the entity's two owner-managers and hence no competitors have been able to discover and replicate the formula. The formula is not protected by a patent or by other means. Many competitors have approached the entity to try to purchase the formula.**

The formula meets the definition of an asset of the entity because, although the formula is not protected by legal rights, the entity has control over the formula by keeping it a secret from its competitors and future economic benefits are expected to flow to the entity. Note however, in accordance with Section 18, internally generated intangible assets are not recognised as assets (see paragraphs 18.4(c), 18.14 and 18.15).

Ex 32 **An entity has developed a successful brand that allows the entity to charge a premium for its products. The entity continues to spend large amounts of money on maintaining and developing the brand (eg sponsoring local sports events, sponsoring select cultural events and advertising the brand).**

The brand probably meets the first part of the definition of an asset because the entity has control over the use of the brand and future economic benefits are expected to flow to the entity. However, due to the ongoing maintenance and development costs, it may be difficult to reliably measure the cost or value of the brand. Since both requirements are necessary to recognise an asset, the entity may conclude that the brand is not an asset as defined.

Note that the internal costs incurred in developing the brand do not satisfy the specific recognition criteria in paragraph 18.4. The expenditures incurred for sponsorships and advertising are not recognised as an intangible asset because the brand results from expenditure incurred internally on an intangible item. The costs are recognised as an expense as they are incurred (see paragraphs 18.4(c), 18.14 and 18.15).

Ex 33 **An entity acquires a competitor's brand in a separate acquisition for CU100,000. The entity uses the brand to charge a premium for the products that it manufactures.**

Similar to the previous example, the brand probably meets the first part of the definition of an asset of the entity because, the entity has control over the use of the

brand and future economic benefits are expected to flow to the entity. In contract to the previous example, since the entity acquired the brand at a market related price paid in an arms transaction to another party that had previously developed the brand, it is possible to reliably measure the cost or value of the brand. Therefore the entity may conclude that the brand is an asset as defined.

Note: The entity recognises the brand acquired from its competitor as an intangible asset. The CU100,000 incurred to acquire the brand satisfies the recognition criteria for an asset (the probability recognition criterion is always considered as being satisfied for intangible assets separately acquired—see paragraph 18.7).

Amounts incurred subsequently by the entity for maintaining and improving the brand will be recognised as an expense as incurred (ie expenditures incurred for sponsorships and advertising relating to the brand cannot be separated from costs incurred in respect of the business as a whole—see paragraphs 18.4(c), 18.14 and 18.15).

2.38 An entity shall not recognise a **contingent asset** as an asset. However, when the flow of future economic benefits to the entity is virtually certain, then the related asset is not a contingent asset, and its recognition is appropriate.

Notes

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. They are discussed in more detail in Section 21 Provisions and Contingencies (specifically paragraph 21.13). The requirement that they are only recognised if the flow of future economic benefits is virtually certain creates a higher hurdle for recognition than other types of assets.

Examples—contingent assets

Ex 34 **An entity is taking legal action seeking damages for patent infringement from its competitor. The outcome of the case is uncertain. However, it is probable that the court will order the competitor to pay the entity damages.**

The entity has a probable future benefit arising from the court ordering the competitor to pay the entity damages. However, the existence of that benefit will only be confirmed by the occurrence of a future event outside of the control of the entity (the court decision). The receipt of the benefit is not virtually certain, so the entity has a contingent asset. The entity would not recognise an asset. The entity should disclose the contingent asset as set out in paragraph 21.16 because an inflow of economic benefits is probable, but not virtually certain.

Ex 35 **The facts are the same as in Example 34. However, in this example, it is virtually certain that the court will order the competitor to pay damages to the entity.**

The entity has a virtually certain future benefit arising from the court ordering the competitor to pay the entity damages. The existence of that benefit will only be confirmed by the occurrence of a future event outside of the control of the entity (the court decision). However, the receipt of the benefit is virtually certain, so the entity will recognise an asset. The entity should recognise an asset. It is not a contingent asset because the virtual certainty of receiving benefits removes the contingency.

Ex 36 **The facts are the same as in Example 34. However, in this example, it is probable that the court will rule in favour of the competitor (ie it is probable that the entity's case will not be successful).**

The entity has a future benefit arising from the court ordering the competitor to pay the entity damages. The existence of that benefit will only be confirmed by the occurrence of a future event outside of the control of the entity the court decision). However, the receipt of the benefit is neither virtually certain nor probably, so the entity has neither an asset nor a contingent asset. The entity would not recognise an asset, and would not be required to disclose a contingent asset, however the entity may choose to provide disclosure about the court case.

Note, an outflow of economic benefits might be required to cover the legal fees of the case. The entity should consider whether it needs to recognise a provision for these costs.

Liabilities

2.39 An entity shall recognise a liability in the statement of financial position when:

(a) the entity has an obligation at the end of the reporting period as a result of a past event;

(b) it is probable that the entity will be required to transfer resources embodying economic benefits in settlement; and

(c) the settlement amount can be measured reliably.

2.40 A **contingent liability** is either a possible but uncertain obligation or a present obligation that is not recognised because it fails to meet one or both of the conditions (b) and (c) in paragraph 2.39. An entity shall not recognise a contingent liability as a liability, except for contingent liabilities of an acquiree in a **business combination** (see Section 19 *Business Combinations and Goodwill*).

Examples—recognise a liability or disclose a contingent liability

Ex 37 **In 20X5 a lawsuit was brought against an entity by a group of people collectively seeking compensation for damages to their health as a result of contamination to the nearby land, which they believe to be caused by waste from that entity's production process. It is doubtful whether the entity is the source of the contamination because many entities operate in the same area producing similar waste and the source of the leak is unclear. The entity denies any wrongdoing because it has taken precautions to avoid such leaks and is vigorously defending the case. However, the entity cannot be certain that it has not caused the leak and the true offender will become known only after extensive testing. The entity's lawyers expect a court ruling in approximately two years. Up to the date of approval (ie authorisation) of the financial statements for the year ended 31 December 20X5, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares its financial statements for the year ended 31 December 20X6, owing to developments in the case, the entity has been found liable and its lawyers advise it is probable the entity will be required to pay compensation.**

At 31 December 20X5 on the basis of the evidence available when the financial statements were approved, the entity has a possible but uncertain obligation. No provision is recognised. The possible obligation is disclosed as a contingent liability unless the probability of any outflow is regarded as remote.

At 31 December 20X6 the entity has a present obligation and, on the basis of the evidence available, an outflow of resources embodying economic benefits in settlement is probable. Therefore, a provision is recognised for the best estimate of the amount required to settle the obligation. Information about the lawsuit is disclosed in the financial statements.

Ex 38 **The facts are the same as in Example 37. However, in this example, the entity (subsidiary) was acquired by another entity (parent) on 31 December 20X1. In this example, taking account of all of the available evidence, it is probable that the entity will successfully defend the court case (ie an outflow of resources embodying economic benefits in settlement is not probable and the entity has a contingent liability).**

On 31 December 20X1, in accordance with Section 19, the group (parent and subsidiary viewed as a single entity) recognises a liability for the possible obligation (contingent liability) if its fair value can be measured reliably (see paragraph 19.15(d)).

Income

2.41 The recognition of income results directly from the recognition and measurement of assets and liabilities. An entity shall recognise income in the statement of comprehensive income (or in the income statement, if presented) when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.

Example—income recognition

Ex 39 **On 1 January 20X1 an entity acquired a property for CU1,000. It rents the property to independent third parties under operating leases in return for rental payments. In 20X1 CU90 lease rentals accrued to the lessee (the tenant paid the CU90 rent to the entity on 1 January 20X2).**

The entity measures investment property, after initial recognition, at fair value. At 31 December 20X1 the fair value of its investment property was CU1,100.

The entity recognises income in the year ended 31 December 20X1 as follows:

- CU90 rental income (ie the increase in the asset (rent receivable))– CU90 receivable by the entity from the lessee at 31 December represents an increase in future economic benefits arising from the increase in a receivable asset. ; and
- CU100 increase in the fair value of its asset (investment property)—CU1,100 at 31 December 20X1 less CU1,000 at 1 January 20X1 represents an increase in the expected future economics arising from the investment property.

Expenses

2.42 The recognition of expenses results directly from the recognition and measurement of assets and liabilities. An entity shall recognise expenses in the statement of comprehensive income (or in the income statement, if presented) when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

Example—expense recognition

Ex 40 **An entity recognised a liability (provision for a lawsuit) at CU40,000 in its statement of financial position at 31 December 20X1. At 31 December 20X2, the entity remeasured the liability at CU90,000. CU3,000 of the increase in the provision is attributable to the unwinding of the discount that had been applied to account for the time value of money (ie the increase in the CU40,000 because it is one year closer to settlement) and the remainder of the increase is attributed to better information becoming available on which to base the estimates.**

The increase of CU50,000 is recognised as an expense in profit or loss for the year ended 31 December 20X2 (ie CU90,000 at 31 December 20X2 less CU40,000 at 31 December 20X1). Of that CU50,000 expense, CU3,000 is a finance cost and the remaining CU47,000 is a loss from a lawsuit (see paragraph 21.11).

Total comprehensive income and profit or loss

2.43 Total comprehensive income is the arithmetical difference between income and expenses. It is not a separate element of financial statements and a separate recognition principle is not needed for it.

2.44 Profit or loss is the arithmetical difference between income and expenses other than those items of income and expense that this Standard classifies as items of other comprehensive income. It is not a separate element of financial statements and a separate recognition principle is not needed for it.

2.45 This Standard does not allow the recognition of items in the statement of financial position that do not meet the definition of assets or of liabilities regardless of whether they result from applying the notion commonly referred to as the 'matching concept' for measuring profit or loss.

Measurement at initial recognition

2.46 At initial recognition, an entity shall measure assets and liabilities at historical cost unless this Standard requires initial measurement on another basis such as fair value.

Subsequent measurement

Financial assets and financial liabilities

2.47 An entity measures basic **financial assets** and basic **financial liabilities**, as defined in Section 11 *Basic Financial Instruments*, at amortised cost less **impairment** except for investments in non-convertible preference shares and non-puttable ordinary or preference shares that are **publicly traded** or whose fair value can otherwise be measured reliably without undue cost or effort, which are measured at fair value with changes in fair value recognised in profit or loss.

2.48 An entity generally measures all other financial assets and financial liabilities at fair value, with changes in fair value recognised in profit or loss, unless this Standard requires or permits measurement on another basis such as cost or amortised cost.

Non-financial assets

2.49 Most non-financial assets that an entity initially recognised at historical cost are subsequently measured on other measurement bases. For example:

(a) an entity measures property, plant and equipment either at the lower of cost less any accumulated depreciation and impairment and the **recoverable amount** (cost model) or the lower of the revalued amount and the recoverable amount (revaluation model);

(b) an entity measures inventories at the lower of cost and selling price less costs to complete and sell; and

(c) an entity recognises an impairment loss relating to non-financial assets that are in use or held for sale.

Measurement of assets at those lower amounts is intended to ensure that an asset is not measured at an amount greater than the entity expects to recover from the sale or use of that asset.

2.50 For the following types of non-financial assets, this Standard permits or requires measurement at fair value:

(a) investments in **associates** and **joint ventures** that an entity measures at fair value (see paragraphs 14.10 and 15.15 respectively);

(b) **investment property** that an entity measures at fair value (see paragraph 16.7);

(c) agricultural assets (**biological assets** and **agricultural produce** at the point of harvest) that an entity measures at fair value less estimated costs to sell (see paragraph 34.2); and

(d) property, plant and equipment that an entity measures in accordance with the revaluation model (see paragraph 17.15B).

Liabilities other than financial liabilities

2.51 Most liabilities other than financial liabilities are measured at the best estimate of the amount that would be required to settle the obligation at the **reporting date**.

Offsetting

2.52 An entity shall not offset assets and liabilities, or income and expenses, unless required or permitted by this Standard:

(a) measuring assets net of valuation allowances is not offsetting. For example, allowances for inventory obsolescence and allowances for uncollectible receivables.

(b) if an entity's normal operating activities do not include buying and selling non-current assets, including investments and operating assets, then the entity reports gains and losses on disposal of such assets by deducting from the proceeds on disposal the **carrying amount** of the asset and related selling expenses.

Examples—offsetting required

Ex 41 **On 1 November 20X5 an entity 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.**

Applying 2.52, on 1 November 20X5 the entity recognises a gain on the disposal of the building of CU1,140,000 in profit or loss.

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

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

Ex 42 **A defined benefit plan 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 entity's obligations under the plan was appropriately estimated at CU200,000. Furthermore, the fair value of the plan assets out of which the obligations are to be settled directly was determined at CU180,000 as at 31 December 20X1.**

Applying 2.52, and entity would present separately the present value of the entity's obligations (liability of 200 000) and the plan assets (asset of 180 000). However, paragraph 28.15 overrides 2.52. At 31 December 20X1 the entity must, in accordance with paragraph 28.15, recognise a liability (employee benefit: post-employment benefits) of CU20,000 for its defined benefit plan (ie CU200,000 obligation less CU180,000 plan assets set aside to fund the defined benefit obligation).

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* Standard to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty are useful in assessing an entity's financial position, performance and cash flows. Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and 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 about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have 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 *IFRS for SMEs* 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 *IFRS for SMEs* Standard. However, in some cases significant judgement is required (eg in particular circumstances, assessments of materiality, economic substance and the probability of future economic benefit flows might require significant judgements). Moreover, when the *IFRS for SMEs* 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, that results in information relevant to the economic decision-making needs of users and is reliable. 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.

Materiality assessments

Information is material if its omission or misstatement could influence the economic decisions of users made on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement 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 may 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.

Substance over form

When the economic substance differs from that set out in a legal form, transactions and other events and conditions must be accounted for and presented in accordance with the economic substance. Examples of the application of this concept are found in:

- Section 20 *Leases* for contracts that provide rights to capacity but do not take the legal form of a lease;
- Section 22 *Liabilities and Equity*, which requires some puttable ordinary shares to be classified as liabilities of the issuer; and
- Section 23 *Revenue* for identifying the revenue transaction in multiple-element sales and for segmenting and combining construction contracts.

Applying the principles developed from the substance-over-form concept may require significant judgement.

Undue cost or effort

When a specific requirement allows for an undue cost or effort exemption management must use its judgement to the entity's specific circumstances. This judgement requires careful consideration of how the economic decisions of those that are expected to use the financial statements could be affected by not having the information. These considerations may require significant judgement.

Probability of future economic benefit

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

Accounting policies

When the *IFRS for SMEs* Standard does not specifically address a transaction, or other event or condition, management must use its judgement in developing an accounting policy for that transaction, or other event or condition, in accordance with paragraphs 10.4 and 10.5 of the *IFRS for SMEs* Standard. If, in making these judgements, management cannot use the requirements and guidance in the *IFRS for SMEs* Standard dealing with similar and related issues, it considers the definitions of the elements of the financial statements, the recognition criteria and measurement concepts and pervasive principles in Section 2 (see paragraphs 10.4 and 10.5).

COMPARISON WITH FULL IFRS STANDARDS

In 2018 the Board 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. Some of the more significant changes that are relevant to this module include:

- a much-expanded chapter on measurement that considers historical cost and current value approaches in much greater detail and discusses factors to consider when selecting a measurement basis;
- a new chapter on presentation and disclosure that outlines objectives and principles, including when to classify income and expenses in other comprehensive income;
- guidance on when assets and liabilities are derecognised from financial statements;
- updated definitions of an asset and a liability; and
- updated recognition criteria that clarify the role of probability.

It should also be noted that the 2018 *Conceptual Framework* does not have an equivalent to the undue cost or effort exemption contained in Section 2. The cost constraint discussed in the 2018 *Conceptual Framework* is focused on the development of reporting requirements, rather than the implementation of those requirements.

Module 2—Concepts and Pervasive Principles

TEST YOUR KNOWLEDGE

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

Once you have completed the test, check your answers against those set out below this test.

Assume that all amounts are material.

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* 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 financial information about the reporting entity;

☐ (d) to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs (eg investors and creditors).

Question 2

The qualitative characteristic 'prudence' implies that in preparing financial statements management should

☐ (a) have a bias toward understating assets and income and overstating liabilities and expenses;

☐ (b) have a bias toward overstating assets and income and understating liabilities and expenses;

☐ (c) be neutral (ie no bias) and cautious in the exercise of judgements needed in making estimates;

☐ (d) if permitted to do so, use full IFRS Standards rather than the *IFRS for SMEs* Standard.

Question 3

Materiality depends on:

☐ (a) the size of the item;

☐ (b) the nature of the item;

☐ (c) the size and nature of the item or error judged in the surrounding circumstances.

Question 4

Which of the descriptions below best describes the qualitative characteristic 'reliability'?

☐ (a) information is reliable when it is measured precisely (ie little or no uncertainty in measurement);

☐ (b) information is reliable when it is measured at historical cost;

☐ (c) information is reliable when it is measured at fair value;

☐ (d) information is reliable when it is free from material error and bias and represents faithfully that which it either purports to represent or could reasonably be expected to represent.

Question 5

Which of the following would be an acceptable reason for using an 'undue cost or effort' exemption that is specified in the *IFRS for SMEs* 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 those expected to use the entity's financial statements would receive.

Question 6

Which of the following is not an element for which there is a concept in Section 2?

☐ (a) asset;

☐ (b) liability;

☐ (c) income;

☐ (d) expense;

☐ (e) other comprehensive income.

Question 7

Expenses are recognised in comprehensive income (ie profit or loss or other comprehensive income)

☐ (a) using the matching basis (ie on the basis of a direct association between the costs incurred and the earning of specific items of income);

☐ (b) using the accrual basis of accounting;

☐ (c) at the discretion of management;

☐ (d) at the discretion of the owners of the entity.

Question 8

The accrual basis of accounting that underlies financial information prepared in accordance with the *IFRS for SMEs* Standard:

☐ (a) specifies that expenses are recognised as an expense in the period in which the income they generate is recognised (a matching concept);

☐ (b) specifies that an entity must be conservative in its accounting (ie understate assets and income and overstate liabilities and expenses);

☐ (c) specifies that an element (asset, liability, equity, income and expense) is recognised when it satisfies the definition and recognition criteria for an element;

☐ (d) specifies that management discretion determines the timing of the recognition of income and expenses.

Question 9

Which of the following satisfies the definition of a liability?

☐ (a) the income generating capacity of a snow ski resort is greatly influenced by the amount of snowfall. Snowfall is erratic. To reduce the volatility in its reported profit, a snow 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, ie 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 damage/loss insurance cover. When the entity suffers damage or loss its 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 is being sued because it breached the patent of one of its competitors. The entity's legal counsel believes that it is more likely than not that the entity will lose the case.

☐ (d) all of the above (ie (a) to (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 they believe 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 a provision for unforeseen possible expenses.

- ☐ (a) because creation of the provision is prudent, it is acceptable accounting;
- ☐ (b) because creation of the provision is common practice in the jurisdiction in which the entity operates, it is acceptable accounting;
- ☐ (c) provided the reason for creating the provision is explained in the notes, it is acceptable accounting;
- ☐ (d) because it does not satisfy the definition of a liability, the entity cannot create a provision for unforeseen possible expenses.

Question 11

Recognition criteria determine when to recognise an item. Measurement is the process of determining the monetary amounts at which to measure an item. Uncertainties about the extent of future cash flows:

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

Module 2—Concepts and Pervasive Principles

Answers

Q1 (d)—see paragraph 2.2
Q2 (c)—see paragraph 2.9
Q3 (c)—see paragraph 2.6
Q4 (d)—see paragraph 2.7
Q5 (c)—see paragraphs 2.14A–2.14D
Q6 (e)—see paragraphs 2.15–2.26
Q7 (b)—see paragraph 2.36
Q8 (c)—see paragraph 2.36
Q9 (c)—see paragraphs 2.15 and 2.20
Q10 (d)—see paragraph 2.20
Q11 (c)—see paragraphs 2.27–2.34