

PART

1

The framework of financial reporting

The search for principles

In this chapter we first introduce the subject matter of the book and explore the role of accounting theory before turning to some of the attempts which have been made to construct a conceptual framework for financial reporting. We examine the ongoing US Conceptual Framework Project and the International Accounting Standards Board (IASB) *Framework for the Preparation and Presentation of Financial Statements* before concentrating on the work of the UK Accounting Standards Board (ASB) that led to the publication of its *Statement of Principles for Financial Reporting* in December 1999.

Introduction

One of the most difficult tasks facing authors is deciding how to start their books. An elegant epigram or an eye-catching sentence might well fix the attention of prospective readers or, more importantly, potential purchasers of the book, but such devices do not seem appropriate in this case. We feel that it would be best to start the book in a fashion which reflects its approach, i.e. we shall adopt a practical stance and start by discussing what we mean by the three words which constitute the title of the book – *Advanced Financial Accounting*. It will be convenient to start at the end of the title and then work back.

A number of definitions of accounting are available in the literature, and of these we will select the oft-quoted description provided by the Committee of the American Accounting Association (AAA), which was formed in order to prepare a statement of basic accounting theory. In its report, which was published in 1966, the Committee defined accounting as:

the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.¹

We feel that the definition is a useful one in that it focuses not on the accounting process itself but on the reasons why information is required. It is all too easy for accountants to become obsessed with the techniques of their craft and to forget that the application of these techniques is not an end in itself but merely a means to an end. In this book we shall constantly reiterate such questions as ‘Why is this information required?’ or ‘How will this data be used?’ We believe that a proper study of accounting must start with an examination of the needs of decision makers.

The distinction between financial and management accounting is a convenient one to make, but it must not be regarded as one which divides the two areas of study into watertight compartments. It would be better if the phrases ‘financial’ and ‘management’ accounting

¹ *A statement of basic accounting theory*, AAA, New York, 1966, p. 1.

were replaced by ‘external’ and ‘internal’ accounting, as management accounting has financial implications while managers have more than a passing interest in financial accounting. But, however one describes the differences, it is generally agreed that financial, or external, accounting is primarily concerned with the communication of information about an entity to those who do not share in its management, while management, or internal, accounting refers to the communication of information to the managers of the particular entity. Thus the American Financial Accounting Standards Board (FASB) has defined financial reporting as activities which are intended to serve ‘the informational needs of external users who lack the authority to prescribe the financial information they want from an enterprise, and therefore must use the information that management communicates to them’.² This is a helpful definition which indicates that in this book we will be concerned with financial information that is given to users rather than information which is required by an individual or group of individuals who are in a position to enforce their request.

A more recent description of the objective served by financial statements has been provided by the UK Accounting Standards Board (ASB), whose publications loom large in this book. In its *Statement of Principles for Financial Reporting*,³ the Board states that:

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

The reference to the making of economic decisions links back to the AAA’s description of accounting and reminds us of the essentially utilitarian nature of the activity. The concept of stewardship reminds us of accounting’s historical roots which were based on the desire of owners of assets to receive reports from their stewards on the way in which the assets entrusted to their charge had been used.

A more modern interpretation of the concept of stewardship suggests that it has two aspects. The obligation to render accounts, or provide financial statements, might be expected to motivate stewards (managers) to act in ways which best serve the interests of owners, while the receipt of such information might help owners make economic decisions (e.g. sell shares or sack the managers), thus indicating that the two purposes of the provision of financial information identified by the ASB are closely interrelated.

Another way in which our attitude to stewardship has changed is that there is now the question of whether stewardship is owed to parties other than the economic owners of the assets. Do managers have an obligation to report to other groups such as employees? Although many would contend that economic ownership is all, and that reporting to other groups is simply a means to the end desired by the owners, there are others who would argue that in a modern business enterprise shareholders are not the only stakeholders entitled to receive reports. We shall return to this theme later in the book.

In this book we shall concentrate on the question of accounting for limited companies. We do, of course, recognise that there are many other forms of entity which are of importance, including charities, universities, central and local government and their associated agencies. Our reason for deciding to concentrate on the topic of limited companies is not because we think that the other forms of entity do not merit the concern of financial accountants, but because we recognise that, at least at present, most accounting courses are concerned with the private profit-seeking sector of the economy. Our readers will appreciate

² Statement of Financial Accounting Concepts (SFAC) 1, *Objectives of Financial Reporting by Business Enterprises*, FASB, Stamford, Conn., 1978, Para. 28.

³ *Statement of Principles for Financial Reporting*, ASB, London, December 1999.

that many of the topics that will be discussed in the context of limited companies are of direct relevance to other forms of economic entity.

We should also provide some indication of the interpretation that should be placed on the adjective ‘advanced’ in the title of this book. It does not mean that the text will concentrate on detailed and complex manipulations of debits and credits, although we shall of course have to deal with such matters from time to time. In the context of this book, ‘advanced’ means that we shall concentrate on the identification, measurement and communication of economic information in the light of our acceptance of the view of the ASB that such information is required to help in decision making. Thus we shall concentrate on such questions as what information is relevant to decision makers, how the information is relevant to decision makers, how the information should be measured, and the manner in which it should be communicated. In so doing we shall describe and evaluate alternative approaches to the solution of accounting problems.

The definitions of accounting which we quoted above stop at the ‘communication’ of information. However, it must be emphasised that the interpretation of information is a vital part of an accountant’s work, and it is clear that this aspect must be regarded as being an integral part of the process of communication. It should be noted that the definition of accounting does not extend to decision making. Of course, many accountants do become involved in decision making, but when they do so they are performing a managerial rather than an accounting role. We would not for one moment wish to argue that accountants should not become involved in management, but it is essential to distinguish between accounting and decision making. It is important that information provided by accountants should be as free as possible from personal bias but, if accountants do not keep the distinction between accounting and decision making clear in their own minds, there is a great danger that they might, possibly quite unconsciously, bias the information provided towards the decision which they would wish to see made.

The above discussion might suggest that we see the work of an accountant as being of a purely technical nature in which he or she is allowed little latitude for professional judgement. This is not the case, because we believe that the accountant must strive to find out and attempt to satisfy the information needs of decision makers and, as we shall show, this is no easy task.

Accounting theory

Academic accountants tend to bemoan the lack of generally accepted accounting theory. This is understandable because theory is the stock in trade of academics. Some ‘practical’ accountants are probably rather pleased that there is no generally agreed theory of accounting because such practical people are suspicious of theory and theorising as they believe that it gets in the way of ‘real work’. However, those who take this view are probably ignorant of the role that theory can play in practical matters and do not realise that an absence of theory does give rise to many real and practical difficulties.

The description of accounting theory provided by Hendriksen shows clearly the practical uses of theory. Hendriksen defines accounting theory as ‘logical reasoning in the form of a set of broad principles that (i) provide a general frame of reference by which accounting practice can be evaluated and (ii) guide the development of new practices and procedures’.⁴

⁴ E.S. Hendriksen and M.F. Van Breda, *Accounting Theory*, 5th edn, R.D. Irwin, Homewood, Ill., 1992.

Expressed in this way, it is obvious that the function of theory is to assist in the resolution of practical problems. The existence of a theory would mean that we could say and explain why, given a number of assumptions, method X (perhaps current cost accounting) is to be preferred to method Y (say historical cost accounting).

There have been numerous attempts to construct a theory of accounting.⁵ In the early stages of development an *inductive* approach was employed. Thus the practices of accountants were analysed in order to see whether patterns of consistent behaviour could be derived from the observations. If a general principle could be observed, then procedures which deviated from it could be castigated as being unsound. These first attempts were mainly directed towards the establishment of explanatory theories, i.e. theories which explained why certain rules were followed.

This approach failed for two main reasons. One is the difficulty of distinguishing consistent patterns of behaviour from a mass of procedures which had developed with the growth of accountancy and the problem of establishing any general set of explanatory statements. The second, and possibly more important, reason was that the approach did not help to improve accounting practice in any significant way. The approach only allowed the theorist to say 'what is' and not 'what ought to be'.

In response to these problems a different method of theory construction emerged in the 1950s. This method was normative in nature, i.e. it was directed towards the improvement of accounting practice. The method also included elements of the deductive approach, which essentially consists of the derivation of rules on the basis of logical reasoning from a basic set of objectives. The theories generally consisted of a mixture of deductive and inductive approaches, the latter being used to identify the basic objectives. These approaches to theory construction were extremely valuable in that they generated a number of books and papers which have had a profound effect on the development of accounting thought, in particular in the area of current value accounting.⁶

Since that time, we have seen the development of numerous bodies throughout the world concerned with setting accounting standards. Perhaps not surprisingly, these standard setters have found it difficult to resolve particular accounting issues, so they have sought to construct a conceptual framework or set of principles which could be used to underpin accounting standards and to provide guidance to practitioners in areas where no accounting standard exists. Although the British Accounting Standards Steering Committee, a predecessor of the ASB, issued a discussion document *The Corporate Report*⁷ as early as 1975, the most ambitious attempt to create such a framework has undoubtedly been that of the Financial Accounting Standards Board (FASB) in the USA. As we shall see, enormous expenditure on this project in the 1970s and early 1980s was not sufficient to prevent it running into difficulties with the consequence that there has been very little output since the mid-1980s.

In spite of these difficulties, the approach of the FASB has had considerable influence on subsequent developments in other countries, including the following attempts to develop conceptual frameworks:⁸

⁵ Hendriksen and Van Breda, *op. cit.*, provides a detailed and authoritative description of these attempts.

⁶ Some of the more important developments are summarised in Chapter 19.

⁷ Accounting Standards Steering Committee, *The Corporate Report*, London, 1975. This important and wide-ranging document did not receive the attention which it deserved because it was followed closely by the publication of the Report of the Inflation Accounting Committee (the Sandilands Report), which was considered to have much greater immediate relevance. We discuss the Sandilands Report in Chapters 19 and 20 of this book.

⁸ This is not intended as an exhaustive list. Many bodies in other countries have attempted to prepare conceptual frameworks and have drawn upon the work of the FASB. Examples include Australia, Canada and New Zealand.

- *Making Corporate Reports Valuable*, Discussion Document by the Research Committee of the Institute of Chartered Accountants of Scotland (ICAS), edited by Peter N. McMonnies, Kogan Page, London, 1988.
- *Framework for the Preparation and Presentation of Financial Statements*, International Accounting Standards Committee (IASC), London, 1989 and, subsequently, adopted by the International Accounting Standards Board (IASB) in April 2001.
- *Guidelines for Financial Reporting Standards*, Report to the Research Board of the Institute of Chartered Accountants in England and Wales by Professor David Solomons, Institute of Chartered Accountants in England and Wales (ICAEW), London, 1989.
- *The Future Shape of Financial Reports*, Discussion paper by the ICAEW Research Committee and the ICAS Research Board, 1991.
- *Statement of Principles for Financial Reporting*, ASB, London, December 1999.

With the exception of the ICAS Discussion Document, *Making Corporate Reports Valuable*,⁹ which takes a much less blinkered approach, all of these documents work within the confines of a typical set of financial statements comprising position statement/balance sheet, performance statement or statements, cash or funds flow statement and supplementary notes. Their basic approach is summarised in Figure 1.1.

As we shall see, problems arise at every stage of the process but, in particular, at the stages of recognition and measurement.

We shall look first at the US Conceptual Framework Project and then briefly at the IASB *Framework for the Preparation and Presentation of Financial Statements* before taking a more detailed look at the development of the ASB's *Statement of Principles*.

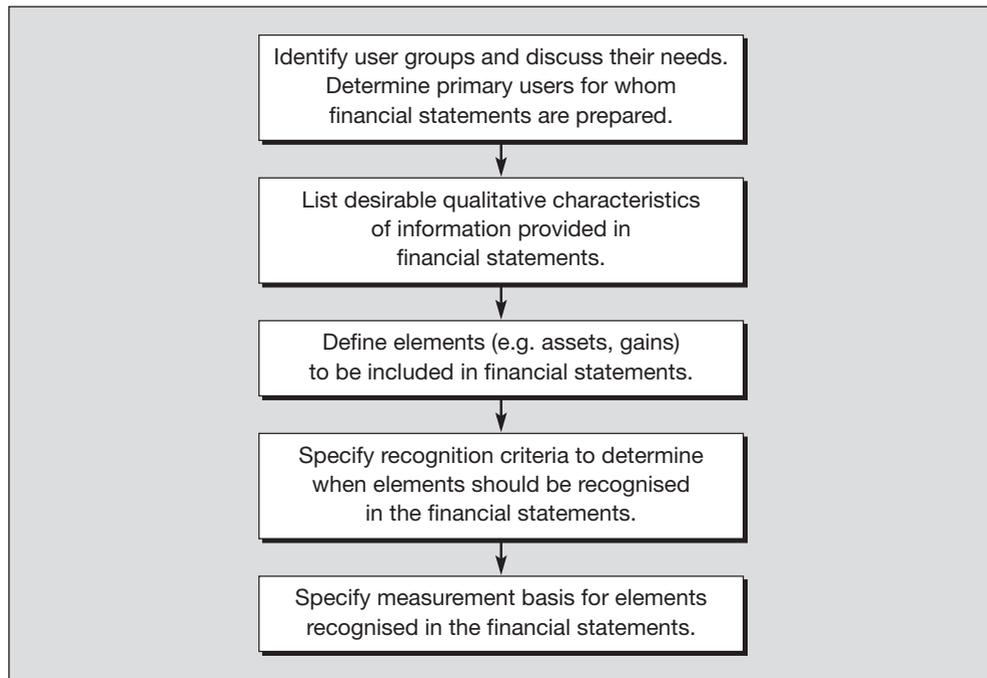


Figure 1.1 Steps in the structure of a typical conceptual framework

⁹ We shall examine some of the ideas of this report later in the book, particularly in Chapters 13 and 21.

The FASB conceptual framework project

Since the mid-1970s, the US FASB has been engaged in a major project to develop a ‘conceptual framework’ for accounting which it defined as:

a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function and limits of financial accounting and financial statements.¹⁰

As the project developed, the FASB issued a number of documents entitled *Statements of Financial Accounting Concepts* (SFACs). For reasons which will be explained below, many observers thought that the project had come to an end with the publication of SFACs Nos 5 and 6 in 1984 and 1985 but, in the late 1990s, the FASB began to develop a further SFAC, which was published as No. 7 in February 2000. The following Statements are relevant in the context of this book:¹¹

- 1 *Objectives of Financial Reporting by Business Enterprises* (November 1978).
- 2 *Qualitative Characteristics of Accounting Information* (May 1980).
- 5 *Recognition and Measurement in Financial Statements of Business Enterprises* (December 1984).
- 6 *Elements of Financial Statements* (December 1985).
- 7 *Using Cash Flow Information and Present Value in Accounting Measurements* (February 2000).

We shall briefly consider each of these in turn.

SFAC No. 1 *Objectives of Financial Reporting by Business Enterprises*

As we have seen earlier in the chapter, the FASB is firmly of the view that financial reporting is intended to help users make decisions:

Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions . . . (Para. 9)

It follows that it is necessary to determine who the users are and to explore the sort of decision which they have to take. The FASB identifies a large number of user groups with both a direct and an indirect interest. The former include such groups as owners, lenders, suppliers, potential investors and creditors, customers, management, directors and taxing authorities while the latter include such groups as financial analysts and labour unions, who advise those with a direct interest. In spite of recognition of these user groups and discussion of their needs, the Statement comes to the conclusion that:

. . . Thus, financial reporting should provide information to help investors, creditors and others assess the amounts, timing and uncertainty of prospective net cash inflows to the related enterprise. (Para. 37)

While some find it difficult to accept that this focus on investors and creditors follows logically from the identification of so many user groups and the discussion of their needs, the next step in the logic seems to be even more suspect:

¹⁰ *Scope and Implications of the Conceptual Framework Project*, FASB, Stamford, Conn., 1976, p. 2.

¹¹ SFAC No. 3 was superseded by SFAC No. 6 and SFAC No. 4 was concerned with Objectives of Financial Reporting by Nonbusiness Organizations, which is outside the scope of this book.

Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity) and the effects of transactions, events and circumstances that change resources and claims to those resources. (Para. 40)

A cynical observer might comment that it is extremely convenient that the outcome of the user-oriented approach is the conclusion that users need the sort of reports that they have traditionally received in the past, namely a position statement or balance sheet together with an income statement!

SFAC No. 2 *Qualitative Characteristics of Accounting Information*

In SFAC No. 2, the FASB specifies a hierarchy of desirable characteristics for accounting information. Decision usefulness is paramount and to be useful information must be both relevant and reliable. While the statement provides numerous other desirable qualities in a hierarchy, it clearly recognises that there will often be a conflict between two or more of these characteristics. Thus at the highest level, relevant information may not be reliable while reliable information may not be relevant. We will examine a similar attempt to specify desirable characteristics later in the chapter within the context of the UK ASB's *Statement of Principles for Financial Reporting*.

SFAC No. 6 *Elements of Financial Statements* (superseded SFAC No. 3)

This SFAC provides definitions of the ten elements of financial statements, namely:

- Assets
- Liabilities
- Equity
- Investments by owners
- Distributions to owners
- Comprehensive income¹²
- Revenue
- Expenses
- Gains
- Losses

It follows that nothing should be included in the financial statements unless it satisfies one of the definitions provided. Even then, it should not be included in the financial statements unless it satisfies the recognition criteria laid down in SFAC No. 5.

¹² While other terms in this list will be familiar to readers, it may be helpful to reproduce the FASB definition of Comprehensive income: 'Comprehensive income is the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners' (SFAC No. 6, Para. 70).

SFAC No. 5 Recognition and Measurement in Financial Statements of Business Enterprises

Having set down the desirable characteristics of accounting information and the definitions of the elements of financial statements, the crucial step in the US Conceptual Framework Project came with SFAC No. 5. This is the document which was intended to specify both when an element should be recognised (that is, included in the financial statements) and, once included, how it should be measured.

The Statement lays down four fundamental recognition criteria but accepts that trade-offs between them will have to be made in practice. It then discusses various different possible bases of measurement which could be used in a set of financial statements, including historical cost, current cost, current market value, net realisable value and present value of future cash flows. However, it does not come down clearly in favour of any one basis of measurement but, rather, leaves the choice of accounting measurement to standard setters and accountants.

For many observers, this was the end of the Conceptual Framework Project for, instead of providing guidance of what should be included in financial statements and what basis of measurement should be used, it failed to do so. Three short quotations from the Statement will help readers appreciate why the late Professor David Solomons described SFAC No. 5 as a ‘cop-out’:¹³

Items currently reported in financial statements are measured by different attributes, depending on the nature of the item and the relevance or reliability of the attribute measured. The Board expects the use of different attributes to continue. (Para. 66)

The concept of earnings described in this statement is similar to net income in present practice . . . (Para. 33)

The Board expects the concept of earnings to be subject to the process of gradual change or evolution which has characterised the development of net income . . . (Para. 35)

Here was a framework designed to help standard setters improve financial reporting providing little guidance but rather expecting things to continue much as they had done before! Such an outcome had been predicted by the British Professor Richard Macve in 1981 in a report commissioned by the Accounting Standards Committee, the predecessor of the ASB.¹⁴ Professor Macve concluded that, while the quest for a conceptual framework or general theory is important in identifying questions that need to be answered, it would be idle to hope that such a framework could be developed that would give explicit guidance on practical problems.

SFAC No. 7 Using Cash Flow Information and Present Value in Accounting Measurements

To the surprise of many, the FASB published two exposure drafts of a proposed Statement of Financial Accounting Concepts in the late 1990s and these were followed, in due course, by the publication of SFAC No. 7 in February 2000.¹⁵ This Statement attempts to provide a

¹³ David Solomons, ‘The FASB’s Conceptual Framework: an evaluation’, *Journal of Accountancy*, June 1986, pp. 114–24.

¹⁴ Richard Macve, *A conceptual framework for financial reporting: the possibilities of an agreed structure*, ICAEW, London, 1981.

¹⁵ The exposure drafts were *Using Cash Flow Information in Accounting Measurements* (June 1997) and *Using Cash Flow Information and Present Value in Accounting Measurements* (March 1999).

framework for the use of present values of future cash flows as a basis for accounting measurement. In the view of SFAC No. 7, where present values are used, the objective should be to arrive at the price of an asset or liability in a hypothetical market. While recognising that present values will often be calculated by discounting the most likely outcome by a risk-adjusted discount rate, the FASB would prefer to see present values reflecting any uncertainty inherent in the future cash flows by using expected cash flows, that is possible cash flows weighted by their probability of occurrence, discounted at a risk-free rate of interest. The Statement is quite clear in proposing that the calculation of the present value of liabilities should reflect the credit standing of the particular entity for which the valuation is being calculated.

SFAC No. 7 is a difficult and rather rambling read and, as with the earlier Statements, it is difficult to envisage it providing much help in the solution of problems of financial reporting in the foreseeable future.

In spite of Professor Macve's conclusion and the difficulties which have been faced by the FASB in applying their Conceptual Framework in practice, other bodies have continued their search for this Holy Grail and we turn next to the attempt of the IASC.

The IASC/IASB framework

Given that national standard setters, like the FASB and ASB, were facing difficulties in resolving many accounting issues, it is perhaps not surprising that the IASC, with members drawn from some 100 countries, faced even greater difficulties.¹⁶ It too attempted to construct a conceptual framework although on a much less grand scale than that which was originally envisaged by the FASB.

The IASC published its extremely short *Framework for the Preparation and Presentation of Financial Statements* in July 1989 and we may immediately obtain a feel for its contents by listing the major headings of the document:

- Introduction
- The Objective of Financial Statements
- Underlying Assumptions
- Qualitative Characteristics of Financial Statements
- The Elements of Financial Statements
- Recognition of the Elements of Financial Statements
- Measurement of the Elements of Financial Statements
- Concepts of Capital and Capital Maintenance

Most of these may be clearly related to the relevant Statements of Financial Concepts of the FASB, which we have outlined above. The additions are sections on 'Underlying Assumptions' and 'Concepts of Capital and Capital Maintenance'. The first of these describes the accruals basis and going concern concept while the second outlines the major capital maintenance concepts which can be used in the measurement of profit, namely financial capital maintenance (nominal or real) and physical capital maintenance, respectively, without choosing between them.¹⁷

¹⁶ We discuss the increasing role of the IASC and its successor, the International Accounting Standards Board (IASB) in international standard setting in Chapter 3, Sources of authority: the rise of international standards.

¹⁷ We will discuss these concepts in considerable depth later in the book, initially in Chapter 4 and subsequently in Part 3.

Yet again, standard setters looking to this framework for help in resolving most accounting issues will be disappointed. Its failings are most evident at the measurement stage. Thus the section on measurement discusses four different measurement bases which are employed to different degrees and in varying combinations in financial statements, namely historical cost, current cost, realisable value and present value. However, no guidance is given on which should be selected for any given element recognised. When this is coupled with the lack of guidance on the capital maintenance concept to be employed in measuring profit for a period, the document seems unlikely to resolve many accounting issues. A quotation from the final paragraph (Para. 110) gives support to this conclusion:

The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is not the intention of the Board of IASC to prescribe a particular model other than in exceptional circumstances, such as for those enterprises reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments.

Well over a decade has now passed but this framework has not been tightened. It was adopted by the IASB in April 2001 but we may rest assured that that body will not be able to resist attempts to improve the framework in due course.

With this background, let us now turn to the attempts of the ASB to develop its *Statement of Principles for Financial Reporting*.

The ASB's *Statement of Principles*

The ASB has been committed to the development of a *Statement of Principles for Financial Reporting* since its formation in 1990. This was made clear in paragraph 4 of the ASB's *Foreword to accounting standards*, issued in June 1993:

FRSs (Financial Reporting Standards) are based upon the Statement of Principles for Financial Reporting currently in issue, which addresses the concepts underlying the information presented in financial statements. The objective of this Statement of Principles is to provide a framework for the consistent and logical formulation of individual accounting standards. The framework also provides a basis on which others can exercise judgement in resolving accounting issues.

Despite this brave statement, the Board managed to issue many FRSs before it published its own *Statement of Principles* in December 1999.

The first attempt

Individual draft chapters of a *Statement of Principles* were issued by the ASB and, following amendment in response to comments, these were collected together in an exposure draft published in November 1995. The headings of the seven chapters in this exposure draft were as follows:

- 1 The objective of financial statements
- 2 The qualitative characteristics of financial information
- 3 The elements of financial statements
- 4 Recognition in financial statements
- 5 Measurement in financial statements
- 6 Presentation in financial statements
- 7 The reporting entity

The first five of these chapters covered material familiar from the FASB *Statements of Financial Accounting Concepts* and the IASC *Framework for the Preparation and Presentation of Financial Statements* which we have discussed above. Chapter 6 specified the contents of a set of financial statements and how information should be presented in those statements. Chapter 7 concerned itself with the treatment of different levels of investment, including subsidiaries, associates and joint ventures.

In the preparation of this draft, the ASB sensibly tried to start with a clean sheet by ignoring the constraints imposed by company law. Appendix 2 to the draft specifically drew attention to a number of important conflicts between the draft *Statement* and the law. However, where such conflicts exist, the principles could only be followed if use were to be made of the true and fair override or if the law were to be changed. The ASB undoubtedly hopes and anticipates that changes in the law will follow general acceptance of its *Statement of Principles*.

The draft *Statement of Principles* adopted a balance sheet focus. Thus, like its predecessors, it provided definitions of assets and liabilities and proposed that only items which satisfy those definitions may be recognised in the balance sheet and then only when certain recognition criteria are satisfied.

Given the greater relevance of current values to decision taking, it proposed a greater use of current values using a concept known as 'value to the business', to which we shall return many times in this book.

Ownership interest is defined as assets less liabilities and the total gains or losses for a period are to be calculated by deducting the opening ownership interest from the closing ownership interest and adjusting for any contributions from or distributions to owners. Such gains or losses were to appear in one of the two performance statements, either in the Profit and Loss Account or, as another gain or loss, in the Statement of Total Recognised Gains and Losses. The draft specified certain rules to guide this selection, in particular that gains and losses on fixed assets, whether realised or unrealised, should appear in the Statement of Total Recognised Gains and Losses rather than in the Profit and Loss Account.

Perhaps not surprisingly, the ASB received more comments on this document than any other document it has published. While many recognised the need for a Statement of Principles, criticism of this particular draft Statement was vociferous, with the firm of Ernst & Young playing a particularly important role.¹⁸ This criticism was such that the ASB withdrew the draft *Statement of Principles* in July 1996 and issued a progress paper entitled 'Statement of Principles for Financial Reporting – the way ahead'. In that document, the ASB stated its intention to issue a revised exposure draft and this was published, rather later than expected, in March 1999.

Although the ASB accused its critics of misunderstanding its proposals, much of the criticism seemed to have been well founded. The balance sheet focus adopted in the draft has a

¹⁸ See, for example: *The ASB's Framework: Time to Decide*, Ernst & Young, London, February 1996; and *The ASB's Statement of Principles – Blueprint or Blind Alley?*, Ron Paterson (Ernst & Young), University of Wales (Aberystwyth), February 1998.

number of strengths but does not seem in accord with either current practice or the principles on which the Board has based some of its published standards. The draft certainly failed to provide sufficient justification for such a fundamental departure from a position with which many accountants feel comfortable.

Although they may be accused of overlooking the fact that a large proportion of listed companies have revalued at least some of their fixed assets on a piecemeal basis, critics also attacked the proposals to move towards a greater use of current values. They argued that such values are less reliable and that, even if all assets and liabilities recognised in a balance sheet were to be shown at current values, the total ownership interest would not represent the wealth or value of the business as discussed in economists' models. Given this, any measure of gains and losses based upon comparing two such balance sheet totals is unlikely to provide a sensible measure of the increase in the wealth of owners.

The way in which gains and losses were to be recognised in either the Profit and Loss Account or the Statement of Total Recognised Gains and Losses also came in for criticism. While the authors would applaud the attempts of the ASB to discard the confusing and rather unhelpful distinction between realised and unrealised profit, it is not surprising that practitioners, who have worked with such concepts for the whole of their working lives, were not willing to give them up without a fight.

With this brief look at the major criticisms made of the first draft Statement of Principles, let us now turn to the revised exposure draft issued in March 1999.

The revised exposure draft

The revised exposure draft was issued in March 1999, this time accompanied by an introductory booklet and a technical supplement. The introductory booklet contained both a question and answer section and an overview of the draft statement. The technical supplement sets out the reasons for some of the Board's conclusions and why it had rejected possible alternatives. Having been taken by surprise by the negative reaction to the first exposure draft, the ASB was clearly concerned to defuse criticism of this second attempt at developing a Statement of Principles and took great pains to explain and sell its revised draft. Skilful presentation, coupled with a clear exposition of the limited role of the Statement and the considerable flexibility which it still allows, appeared to defuse criticism of the revised draft and permitted the issue of the actual *Statement of Principles for Financial Reporting* later that same year, in December 1999.

The Statement of Principles

The *Statement of Principles for Financial Reporting* contains the same eight chapters as the revised exposure draft with only minor changes to the words and layout. These chapters are:

- 1 The objective of financial statements
- 2 The reporting entity
- 3 The qualitative characteristics of financial information
- 4 The elements of financial statements
- 5 Recognition in financial statements
- 6 Measurement in financial statements
- 7 Presentation of financial information
- 8 Accounting for interests in other entities

We shall provide a brief synopsis of each of these chapters before assessing the extent to which the *Statement* is likely to contribute to an improvement in the quality of future accounting standards.

Chapter 1 The objective of financial statements

Perhaps not surprisingly the *Statement of Principles* provides us with the following objective:

The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions. (p. 16)

It identifies a number of users of general-purpose financial reports and discusses their needs for information. The user groups include investors, lenders, suppliers and other trade creditors, employees, customers, governments and their agencies and the public. Like the US Conceptual Framework Project, discussed above, the *Statement of Principles* comes to the conclusion that it is possible to meet the objective by focusing exclusively on the needs of investors, which it describes as the defining class of user.

It concludes that investors and others need information about the reporting entity's financial performance and financial position to help them to evaluate the entity's ability to generate cash (including the timing and certainty of its generation) and to assess its financial adaptability.

Chapter 2 The reporting entity

This chapter specifies the boundary of the reporting entity by reference to the scope of control. Thus an entity with direct control of its activities, assets and liabilities should prepare single entity financial statements while an entity which also has indirect control of the activities, assets and liabilities of a subsidiary should also prepare consolidated financial statements.

Control has two aspects: first, the ability to deploy the economic resources involved and, second, the ability to benefit (or to suffer) from this deployment. The *Statement* makes it clear that it is the relationship existing between entities in practice, rather than the theoretical level of influence, that is to be considered in determining whether or not control exists.

Chapter 3 The qualitative characteristics of financial information

The *Statement* sets out the desirable characteristics of financial information in a hierarchy which we have reproduced as Figure 1.2. To be useful financial information must be (i) relevant to users, (ii) reliable, (iii) comparable and (iv) understandable.

Financial information is relevant if it would influence economic decisions and it would be able to do this if it has predictive value or confirmatory value. Information with predictive value would help users to assess what is likely to happen in future while information with confirmatory value would help them to confirm or correct previous predictions which they have made. In many, if not most, cases information will have both confirmatory and predictive value.

To be reliable, information must be free from material error and possess certain subsidiary characteristics:

- *Faithful representation*. It must faithfully represent what it purports to represent so that, for example, the substance of a transaction must be portrayed when this differs from its legal form.

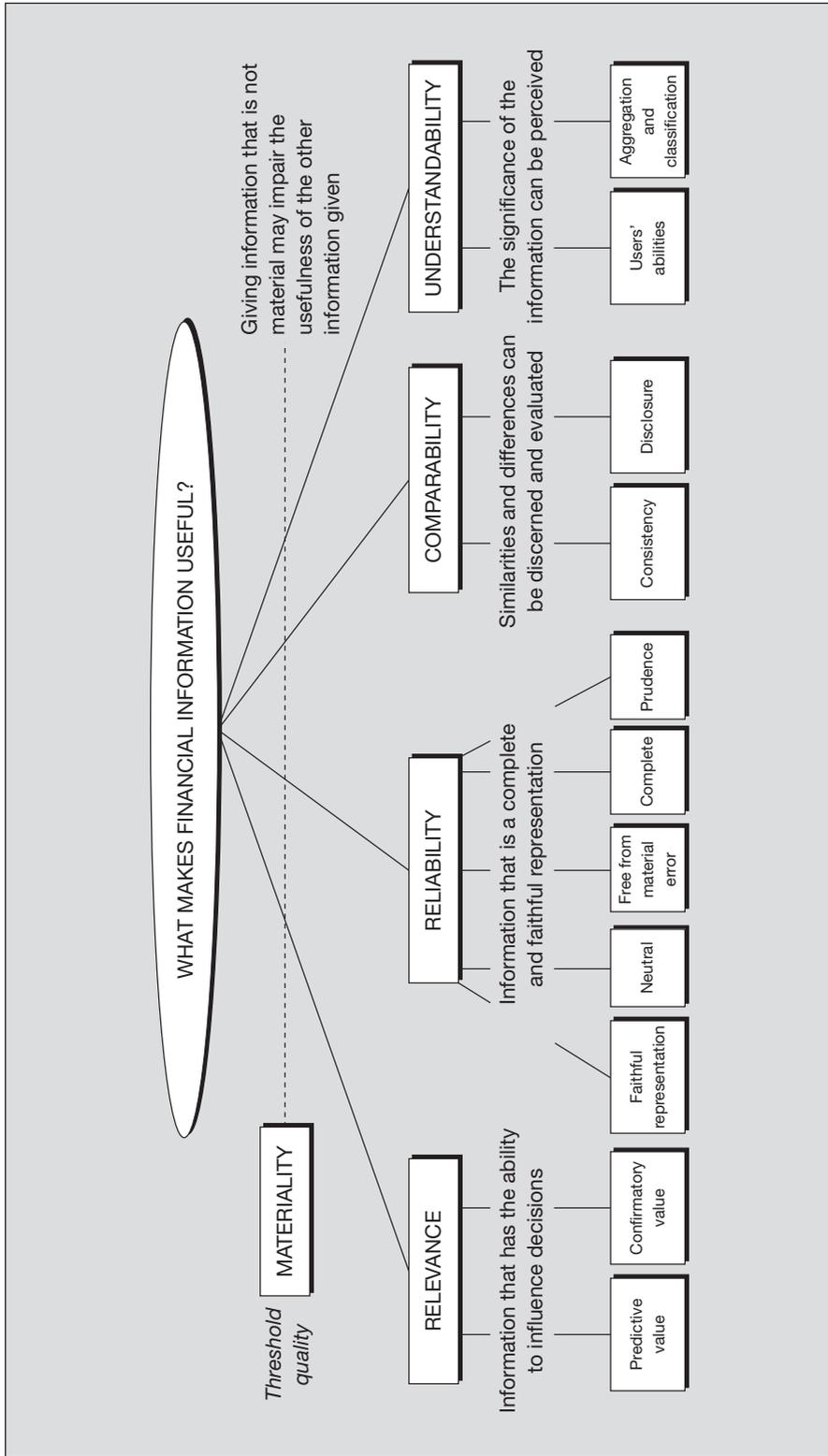


Figure 1.2 The qualitative characteristics of financial information

Source: *Statement of Principles for Financial Reporting*, Accounting Standards Board, December 1999, p. 34. © ASB Publications Limited 2000. Reproduced with permission.

- *Neutral.* The information should be neutral, in other words, it should not be subject to deliberate or systematic bias. We shall have more to say about this when we discuss prudence below.
- *Free from material error.* Information which includes a material error is unlikely to be reliable.
- *Complete.* It should be complete to the extent possible.
- *Prudent.* In the Statement, prudence is defined as follows:

. . . 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 gains and assets are not overstated and losses and liabilities are not understated. In particular, under such conditions it requires more confirmatory evidence about the existence of, and a greater reliability of measurement for, assets and gains than is required for liabilities and losses. (Para. 3.19)

This definition of prudence still contains an element of bias insofar as it specifically warns against the overstatement of gains and assets but is silent on the understatement of gains and assets and warns against the understatement, but not the overstatement, of losses and liabilities. Even so, the new definition does involve some significant implications in that it requires that the concept must be applied within the bounds of reasonable estimates and hence renders the making of excessive provisions or the creation of hidden reserves unacceptable. The definition is not, however, one that is amenable to objective interpretation so disputes between directors and auditors about what is or is not prudent are unlikely to disappear. A message of some of the causes célèbres of 2001 and 2002 might suggest that, perhaps contrary to expectations, the auditors may not always be the more prudent party!

Information should be comparable both for a reporting entity over time and across different reporting entities. This is a tall order but, in particular, requires disclosure of accounting policies as well as of details of changes and the effects of changes in accounting policies.

In order to specify understandability as a desirable characteristic, it is necessary to make some assumption about the ability of users. The ASB assumes that the targeted users ‘have a reasonable knowledge of business and economic activities and accounting and a willingness to study with reasonable diligence the information provided’ (Para. 3.27(c)). However, this is qualified a little later when it is stated that ‘information that is relevant and reliable should not be excluded from the financial statements simply because it is too difficult for some users to understand’ (Para. 3.37).

The *Statement* clearly recognises that there will be conflicts between desirable characteristics such that trade-offs will be necessary. One example of such a conflict is between relevance and reliability: timely information may be highly relevant but not very reliable in an uncertain world but, if we wait for reliable information, it may no longer be timely and therefore no longer relevant. Another example is the conflict between neutrality and prudence, both subsidiary characteristics of reliability, to which we have drawn attention above.

Chapter 4 The elements of financial statements

This chapter defines seven elements of financial statements:

- assets
- liabilities
- ownership interest
- gains
- losses
- contributions from owners
- distributions to owners

Ownership interest is defined as assets less liabilities while gains and losses, contributions from owners and distributions to owners are defined by reference to various changes in ownership interest. The crucial definitions are therefore those for assets and liabilities, which clearly demonstrates the determination of the ASB to retain a balance sheet focus in spite of the heavy criticism of that approach following publication of the first exposure draft:

Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. (Para. 4.6)

Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events. (Para. 4.23)

We shall consider these terms in considerable detail later in the book, particularly in Chapters 5 and 7.

Chapter 5 Recognition in financial statements

There are two prongs to the recognition of transactions or events in a set of financial statements: first, there must be sufficient evidence that an asset or liability has been created or that there has been an addition to an asset or liability. Second, the new asset or liability, or addition thereto, must be capable of measurement at a monetary amount with sufficient accuracy.

So, to be included in a set of financial statements, the item must satisfy the definition of an element in Chapter 4 of the *Statement of Principles* and must be measured reliably. This would mean that certain expenditure previously treated as a deferred asset, such as deferred advertising expenditure, may not be recognised in future. In this way, the ASB hopes to limit the carrying forward of expenditure to match against perhaps dubious benefits in the future:

The Statement imposes a degree of discipline on this process because only items that meet the definitions of, and relevant recognition criteria for, assets, liabilities or ownership interest are recognised in the balance sheet. (Para. 5.29)

Chapter 6 Measurement in financial statements

Having rejected, perhaps too easily, the notion that individual assets and liabilities should be reported on two or more bases of measurement, the ASB then has to choose whether assets and liabilities should be measured at historical cost or on a basis of measurement that reflects current value. The first exposure draft was explicit that the ASB favoured the use of current value, as can be seen from the following quotation:

The Board therefore believes that practice should develop by evolving in the direction of greater use of current values to the extent that this is consistent with the constraints of reliability and cost. (First exposure draft, Para. 5.38)

This was criticised as an attempt on the part of the ASB to move away from historical cost accounting towards a system of current cost accounting. This the ASB denied and, certainly in the Statement, it is very careful not to expose this hostage to fortune.

The ASB now favours the use of the mixed measurement system, sometimes described as modified historical cost accounting. As envisaged by the *Statement*, some assets will be valued on a historical cost basis while others will be valued at current value. The practice whereby some entities have remeasured their tangible fixed assets at a current value on one

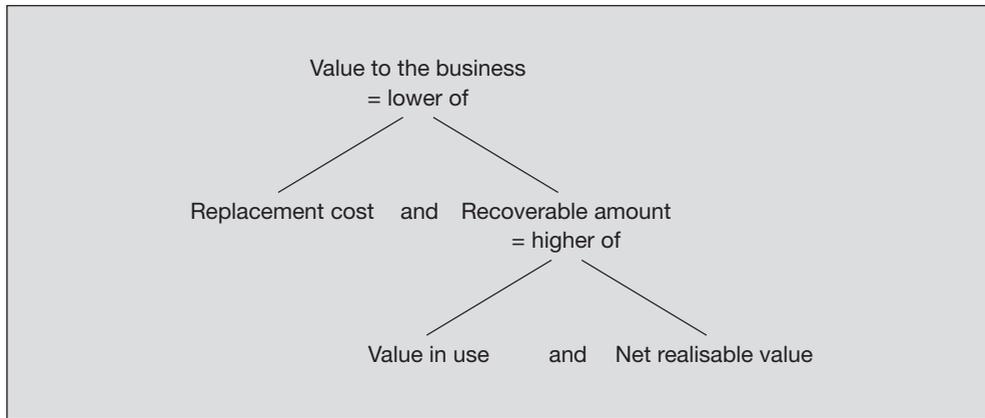


Figure 1.3 The value to the business concept of current value

Source: *Statement of Principles for Financial Reporting*, Accounting Standards Board, December 1999, para. 6.8. © ASB Publications Limited 2000. Reproduced with permission.

particular date but then left that revised value in the financial statements for many years to come is no longer permissible.¹⁹

The concept of current value which the ASB favoured at the date of publication of the *Statement* was value to the business, otherwise known as current cost or deprival value, which it defines as shown in Figure 1.3. However, as part of, or one might suggest as part of the cost of, the programme of convergence between UK and international Financial Reporting Standards, the ASB may have to switch its allegiance from value to the business to the use of fair value which, in its international variant, is firmly based upon market values. We shall return to the concept of current value many times in this book, particularly in Chapters 4, 5, 20 and 21.

If some companies choose to measure assets and liabilities on a historical cost basis while others choose to use current value, it is difficult to see how their respective financial statements will satisfy the desirable quality of comparability.

Chapter 7 Presentation of financial information

According to this chapter, the primary financial statements should comprise three documents:

- Statement of financial performance²⁰
- Position statement or balance sheet
- Cash flow statement

The chapter lays down general principles for presentation of the highly structured and aggregated information necessary in financial statements, the notes to these statements and in the accompanying information. The latter includes such documents as the Chairman's Report, the operating and financial review and five-year historical summaries.

¹⁹ See FRS 15 *Tangible Fixed Assets*, ASB, February 1999.

²⁰ Present standard accounting practice in the UK requires the inclusion of two performance statements: a Profit and Loss Account and a Statement of Total Recognised Gains and Losses. The reference to 'Statement of performance' in the singular anticipated the ASB proposal to combine these statements in the Discussion Paper *Reporting Financial Performance: Proposals for Change*, published in June 1999, and subsequently in FRED 22 *Revision of FRS 3 Reporting Financial Performance*, published in December 2000. We will discuss these proposals in Chapter 11.

Chapter 8 Accounting for interests in other entities

This final chapter deals with the treatment of investments in other entities both in the single-entity financial statements and in consolidated financial statements and is closely related to the material on the reporting entity discussed earlier in Chapter 2 of the *Statement of Principles*.

The *Statement* specifies that the accounting treatment in financial statements should be determined by the degree of influence which the investor has over the investee. When there is significant influence or joint control, the investee is an associate or joint venture and the appropriate method of accounting to be used in the consolidated financial statements is the equity method of accounting. We shall discuss this thoroughly in Chapter 15.

An evaluation of the ASB *Statement of Principles*

As we have seen, one of the major criticisms of the first exposure draft of the *Statement of Principles* was that it adopted a balance sheet focus as opposed to the transactions focused and matching approach of what was then current practice. The *Statement* reiterates this balance sheet focus and considers that it is necessary in order to prevent the attempts by some entities to delay the recognition of items of expenditure by carrying them forward as assets to match against, perhaps dubious, future benefits.

A second major criticism of the first exposure draft was that the ASB was attempting to move away from a system of historical cost accounting to a system of current cost accounting. The ASB has always claimed that this was not its intention although it, quite sensibly, favours the greater use of current values where appropriate. In the *Statement*, it has undoubtedly stepped further back and envisages the use of a mixed measurement system using both historical costs and current values for a long time to come. It has to be recognised that, if entities are permitted to choose whether to use historical cost based values or current values, the desirable quality of comparability across entities is lost completely.

A third criticism of the first exposure draft concerned the way in which gains and losses were divided between the Profit and Loss Account and the Statement of Total Recognised Gains and Losses. There is undoubtedly greater understanding and acceptance of the Statement of Total Recognised Gains and Losses now than when the first exposure draft was published.²¹ Indeed, the Discussion Paper *Reporting Financial Performance: Proposals for change* (June 1999) and subsequent Financial Reporting Exposure Draft (FRED) 22 *Revision of FRS 3 'Reporting Financial Performance'* (December 2000) advocates the combination of both documents into a single Statement of Performance. The major debate has therefore focused on the more detailed proposals in these later documents.

In order to defuse potential criticism, the ASB plays down the importance of the *Statement of Principles* by drawing attention to the many other factors which will have to be considered in setting accounting standards, namely:

- (a) legal requirements,
- (b) cost–benefit considerations,
- (c) industry-specific issues,
- (d) the desirability of evolutionary change, and
- (e) implementation issues.²²

²¹ The first exposure draft was published in November 1995 just some three years after the issue of FRS 3 *Reporting Financial Performance* in October 1992. It was FRS 3 which introduced the requirement for entities to produce the new primary statement, a Statement of Total Recognised Gains and Losses, for accounting periods ending on or after 22 June 1993.

²² *Statement of Principles for Financial Reporting*, Introduction, Para. 14.

In particular, Appendix 1 draws attention to the major conflicts between the *Statement* and existing company law. It recognises very clearly that, as in the past, the law will continue to constrain the activities of the ASB for some considerable time in the future.

All of this leaves the ASB considerable flexibility in future but does raise a fundamental question about the role of any *Statement of Principles for Financial Reporting* if the principles which it lays down can be overridden on so many other grounds!

Summary

In this chapter we have first provided an introduction to this book. We have then stressed the need for ‘theory’ to guide and underpin practice and have examined some attempts to build theories of accounting. After a brief examination of early attempts to develop theory, we have outlined the attempts of the US Financial Accounting Standards Board and International Accounting Standards Committee to develop conceptual frameworks for financial reporting. We have then focused, in more detail, on the work of the ASB in developing its, more modestly titled, *Statement of Principles*.

The *Statement of Principles for Financial Reporting*, published in December 1999, goes to great pains to explain why the ASB has adopted its particular approach and, by so doing, attempted to head off the enormous criticism generated by its first exposure draft on this subject. In this, it appears to have been extremely successful.

Part of the reason for the lack of vociferous criticism is undoubtedly the fact that the *Statement of Principles* leaves the ASB with a considerable amount of flexibility. Inevitably choices will have to be made with trade-offs between different desirable characteristics and judgements on the necessary level of reliability for recognition of elements in the financial statements and the basis of their measurement. As we shall see in various places in the book, there are a number of cases where the ASB has issued accounting standards which are inconsistent with its own *Statement of Principles*. We would do well to remember that the setting of accounting standards is very much a political process which those with vested interests will wish to influence.

We have also seen that, although the *Statement of Principles* is written without taking into account the constraints imposed by the law, these constraints cannot possibly be ignored by those charged with the task of preparing accounting standards. The question of who does and who should set the rules by which the accounting game is played are important and complex issues and these form the subject matter of the next two chapters.

Recommended reading

ASC, *The Corporate Report*, London, 1975.

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E.S. Hendriksen and M.F. Van Breda, *Accounting Theory*, 5th edn, Irwin, Homewood, Ill., 1992.

ICAS, *Making Corporate Reports Valuable*, Kogan Page, London, 1988.

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R. Macve, *A Conceptual Framework for Financial Accounting and Reporting – Vision, Tool or Threat?*, Garland, New York and London, 1997.

- K.V. Peasnell, 'The function of a conceptual framework for corporate financial reporting', *Accounting and Business Research*, Autumn 1982.
- M.K. Power, 'On the idea of a conceptual framework for financial reporting', in *Philosophical perspectives on accounting: Essays in honour of Edward Stamp*, M.J. Mumford and K.V. Peasnell (eds), Routledge, London and New York, 1993.
- D. Tweedie, 'The conceptual framework and the Accounting Standards Board', in *Essays in accounting thought: A tribute to W.T. Baxter*, I. Lapsley (ed.), ICAS, Edinburgh, 1996.

Questions

- 1.1** The ASB's Statement of Principles sets out the concepts which underpin its development of financial reporting standards.

Required

Discuss why the ASB has adopted this conceptual approach and whether any difficulties may be encountered.

ICAEW, Financial Reporting, November 1994 (10 marks)

- 1.2** The Statement of Principles identifies the elements of financial statements. The measurement basis which is applied to these elements can significantly affect the reported financial performance and financial position of a company.

Requirements

(a) Identify the two main measurement bases used in financial reporting and explain how each should be applied in practice. (8 marks)

(b) Explain the impact that subsequent remeasurement of elements of financial statements can have on reported financial performance and financial position. (7 marks)

ICAEW, Financial Reporting, September 2001 (15 marks)

- 1.3** The Statement of Principles deals with the presentation of financial statements i.e. disclosure in primary statements and supporting notes.

Requirements

(a) Discuss the purposes and usefulness of the information on financial position and performance disclosed in published financial statements. (10 marks)

(b) Provide a brief explanation of two inherent limitations of financial statements. (5 marks)

ICAEW, Financial Reporting, December 2001 (15 marks)