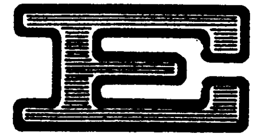

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OBJECTIVES AND CONCEPTS

UNDERLYING FINANCIAL STATEMENTS

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Seventh session
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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ISSUES OF ACCOUNTING AND REPORTING IDENTIFIED DURING THE SIXTH SESSION

Objectives and concepts underlying financial statements

Report of the Secretary-General

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INTRODUCTION

1. At its fifth session, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting decided to take up the subject of objectives and concepts underlying financial statements. This topic has already been addressed by legislators, a number of national and international standard-setting groups and in accounting research and professional practice. Over time, the need to devise an explicit statement or framework that could provide guidance for the formulation and application of accounting standards on a sound and consistent basis has become apparent. The above groups felt that a clear statement of objectives and concepts could better establish the boundaries for the work of standard setters.

2. In a number of countries, the various groups concerned with accounting standards have elaborated frameworks for financial statements. Among those countries are Australia, Brazil, Canada, the United Kingdom of Great Britain and Northern Ireland and the United States of America. This list is not exhaustive but merely illustrative of the interest in this topic. The Fourth Council Directive of the European Communities on annual accounts (1978) may also be considered a basic framework for subsequent accounting directives.

3. There are many reasons for the Group to take up this topic. The most important is that the Group has a specific mandate to make a positive contribution to those national and regional groups that are in the process of standard-setting. In so far as many developing countries have not yet established standard-setting bodies or have done so with limited resources, a clear statement of the objectives and concepts underlying financial statements could provide useful guidance in judging whether proposed national standards will meet their needs. It could also assist those who prepare financial statements in better anticipating and meeting the needs of users. Likewise, it could aid users in better interpreting the information in financial statements. The Group could also benefit from such a statement, since it might provide a common basis for the Group's future discussions. Such a statement could be especially helpful in technical assistance programmes.

4. The present report first discusses the objectives underlying financial statements and describes the users of financial statements and their needs, the characteristics of useful financial information, and the constraints on the provision of such useful information. It then deals with the concepts underlying financial statements and examines accounting concepts and techniques, the elements of financial statements, and the various types of financial statements.

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I. OBJECTIVES OF FINANCIAL STATEMENTS

A. Users of financial statements

5. The objective of financial statements is to provide useful information to users. Some frameworks emphasize the needs of investors and creditors; the present report deals with the needs of all users. Among the users are present and potential investors, lenders, suppliers and customers, employees, home and host Governments, the public at large, and also those who act on behalf of users. 1/ Certain users have the authority to prescribe the information they need, but even those users usually begin with the general-purpose financial statements. Other users, however, rely almost exclusively on the information provided in the general-purpose financial statements, and consequently, such statements must be as meaningful as possible in order to meet their needs. In addition, the application of a sound accounting framework is in the interests of management.

B. Needs of users

6. The objectives of financial statements are defined by the needs of users. In general, information must be provided about the financial position, performance and changes in financial position of an enterprise. Such information is useful to a wide range of users in making decisions and is necessary to keep management accountable for the resources entrusted to it. Financial statements can also provide useful information to Governments for making policy decisions, although Governments often require special-purpose reports as well. 2/ More specifically, a variety of users need to be able to assess an enterprise's performance and thus are interested, among other things, in the enterprise's cash flow. For example, investors must know if they will receive dividends and when they should buy, hold and sell stock. Lenders are interested in determining whether interest and principal on loans will be paid when due. Suppliers, other creditors and customers must determine whether they will be paid on time or will continue to receive a product or service on which they might depend. Employees are interested in the continuation of their employment and, therefore, in the stability and profitability of their employers. Members of the public are also interested in the impact of the enterprise's activities on the general welfare, and there are many groups that help users understand and assimilate the financial information.

II. CHARACTERISTICS OF USEFUL INFORMATION

7. The usefulness of information can be determined by its relevance to the needs of the users and the extent to which users can rely on such information. Relevance and reliability constitute elements of what is referred to as a "true and fair view" in some countries. Financial statements that contain adequate information give such a true and fair view. Other important characteristics of useful information include comparability and understandability. Sometimes, there may be a conflict between these characteristics or some other constraint in providing useful information.

A. Relevance

8. Information is relevant if it is capable of influencing an evaluation or an immediate or future decision, or if it is normally expected to be included in a statement. In order to provide useful information, preparers of statements must be aware of the needs of users. The following factors contribute to the relevance of information provided in financial statements.

1. Timeliness

9. Users benefit more from information that is available at the time it is required. Information provided long after it is needed is of little relevance. For statements whose contents are needed by a number of parties at different times, it is difficult for the preparer to supply the information whenever it is needed. In such cases, a common time requirement is usually set by the regulatory authorities in different countries. Those authorities can also require interim statements. It is expected that enterprises should be capable of issuing financial statements as soon as possible after the end of their accounting year.

2. Materiality

10. Financial statements should disclose all items that are material enough to affect evaluations or decisions. 3/ The preparer of financial statements must decide which of the many details encountered are relevant to the various decisions of the users. The criterion of materiality refers not only to the size of an item in quantitative terms but also to the role that such an item may play. If the omission of an item of information would affect the decisions made by users on the basis of financial statements, such an item is material. However, if an item is immaterial, its inclusion in financial statements may impair their understandability. 4/

3. Predictive value and feedback

11. Although information disclosed in financial statements usually relates to the past and forms the basis on which performance and compliance can be evaluated, the majority of users also require information about the future. Many users wish to predict the future earnings and growth of the reporting enterprise. Information about the enterprise's past and present performance may be useful in predicting its future earnings and thus in evaluating future dividend payments and stock market prices. Forecasts about the enterprise's performance and growth may also help home and host Governments to determine the future course of their economies. To achieve the objectives of financial disclosure, the information published by reporting enterprises must assist users in predicting future prospects of the enterprise. It is this capability that is referred to as "predictive value". The predictions that are made from particular statements become targets against which results in future statements are compared. This quality, which allows predictions from past statements to be compared with the results in present statements, gives financial statements "feedback value".

B. Reliability

12. Reliability is an inherent quality of information that assures its users not only that it corresponds to and satisfactorily reflects the events that it purports to represent, but also that it is free from material error and bias. Financial information should be drawn as directly as possible from the original financial transactions or events. The reliability of financial data and other information is important because a number of judgements depend wholly or in part on them. For example, profit-sharing schemes, corporate taxation, debt agreements, rate regulations and share values (especially if the enterprise is not publicly quoted) all depend on financial statements. The following attributes contribute to the reliability of information in financial statements.

1. Representational faithfulness

13. Reliability requires that information represent what it purports to represent. If, for example, an income statement purports to relate to a certain period, the reported revenue and expenses should, to the extent possible, represent those relating to that period. Therefore, accounting methods and recognition and measurement procedures should be specified, so that users can adequately understand what the information purports to represent and what recognition and measurement procedures have been adopted.

2. Substance over form

14. Transactions and events that form the basis of financial statements are sometimes open to different interpretations. They can be viewed according to their legal form, since most transactions and events are contractual in nature. They can also be viewed according to their economic reality. Enterprises should emphasize the economic substance of transactions and events, even though the legal form may differ from the economic substance and suggest different treatment. Where this approach is precluded by national law, this fact and the effects on the financial position and performance should be indicated.

3. Neutrality

15. Information must be free from bias with respect to various users. Although financial statements are issued to provide information to assist in decision-making, they should not be structured to influence decisions in a predetermined direction or to attain a predetermined result.

4. Prudence

16. Uncertainties play a crucial role in the reliability of information disclosed in financial statements. Although financial statements are based on events that have occurred in the past, many of the events become meaningful only when viewed in

the context of their future outcomes. Those outcomes cannot be determined with precision when the statements are being prepared. It becomes necessary, therefore, for preparers of financial statements to exercise judgement in their estimation of future outcomes. Traditionally, prudence refers to the practice of recognizing potential losses or liabilities more readily than potential gains or assets. Excessive prudence can be just as unrealistic as excessive optimism in that it may, in certain circumstances, be inconsistent with a true and fair view and, in particular, lead to the creation of secret or hidden reserves. 5/

5. Verifiability

17. A transaction or event represented in a financial statement is verifiable if knowledgeable and independent observers would agree that it corresponds to the actual underlying transaction or event with a reasonable degree of precision. Verifiability is concerned with the correct application of measurement methods rather than appropriateness. 6/

C. Comparability

18. Comparability enables users to undertake, in a meaningful way, both inter-temporal and cross-sectional analysis. If financial statements are prepared in a comparable way, then the performance of different enterprises, or of the same enterprise over time, can be examined.

19. The comparability of financial statements is enhanced by the relative stability of accounting policies. Accounting policies specify the methods by which a reporting enterprise measures, accumulates and summarizes the economic events and data in its records. Stability means that no change in accounting policies will be made unless it is clearly necessary.

20. Comparability across enterprises requires that a consistent set of definitions, units of measurement, assumptions, measurement techniques and reporting intervals be applied. It is therefore important for reporting enterprises to disclose the relevant accounting policies adopted. Comparability across enterprises can be promoted if sufficient information is disclosed on accounting policies and changes over time to enable users to adjust financial information according to the changes. If financial statements from enterprises in different countries are to be compared, the user must be aware of the relative differences among national accounting policies. Comparability can be enhanced by the harmonization of national standards or the adoption of international standards.

21. Consistency contributes to the comparability of information over time within an enterprise. Consistency requires that accounting procedures adopted by a reporting enterprise be adhered to over time as a safeguard against bias. However, consistency should not be regarded as a virtue in its own right or be allowed to perpetuate unsound accounting procedures or to hinder improvements in the relevance and reliability of information. The pursuit of consistency should not lead to blind uniformity or preclude changes in accounting methods if they are desirable

over time because of new developments, changing business environments or changes in accounting standards. If the change in any accounting policy has a material effect on the current or subsequent period, the change and its effect should be disclosed so that users can differentiate the results with the change and without it. To enhance the comparability of information, it is desirable for statements issued after the policy change to show corresponding information for the preceding period or periods.

D. Understandability

22. Even if the business transactions that underlie the item being reported on are very complex, this does not excuse enterprises from making comprehensible the information disclosed to users. Understandable information must possess the quality that enables readers to perceive its nature and meaning. Clearly understood information requires that the form of presentation of reports, descriptive headings, concepts measured, assumptions made, bases of classification of data used, narratives in notes and other parts of the reports be relevant, unambiguous, explicit and without unnecessary detail. Consolidated financial statements of enterprises usually reflect the economic and socio-cultural environment of their home countries. Clarity and precision should be preserved when translating financial statements into different languages for users in host countries. Financial statements that are so unclear that only a select few use them defeat the purpose of financial disclosure. On the other hand, users must make a reasonable effort to understand the information and must have some knowledge of business and economic activities.

23. Financial statements should be easier to understand if they are comparable across countries. Harmonization of national standards or the adoption of international standards that leads to greater comparability can therefore be seen as contributing to the understandability of financial statements.

E. Constraints in providing useful information

24. The above characteristics of useful information can be considered by users in evaluating the quality of information received by them, just as they can be considered by preparers in evaluating the information released by them. They can also be used in judging the extent to which accounting and reporting requirements are satisfactory or need improvement. Different users may assign varying degrees of importance to the various characteristics. It is therefore important for those who set accounting standards to be guided by principles that will enable them to determine which of the characteristics should prevail whenever conflicts from their application arise. For example, there might be a conflict between relevance and reliability if it takes so long for information to be known with certainty that it becomes irrelevant.

25. In selecting and applying accounting principles and in deciding which attribute should prevail over another in the presentation of financial statements, preparers should be guided by the following criteria.

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1. Balance between costs and benefits

26. In improving the availability and comparability of financial information, the likely costs and benefits of providing such information must be considered. "Benefits" relate to the overall advantages that the information would give to the users and preparers. "Costs" relate to the cost of providing the information and of monitoring the provision of the information and the cost to users of interpreting and using the information. The costs of providing information should bear a reasonable relationship to the benefits derived therefrom.

2. Size of the reporting entity

27. The extent and nature of the information disclosed should take into account the enterprise's relative size. 7/

3. Confidentiality

28. It is necessary to take into account the need of enterprises to maintain business confidentiality in sensitive areas, particularly so as not to jeopardize their competitive position. 8/

III. CONCEPTS UNDERLYING FINANCIAL STATEMENTS

A. Elements of financial statements

29. Financial statements normally consist of the balance sheet, income statement, statement of changes in financial position, statement of allocation of net income, and notes to the financial statements, as well as any explanatory material or schedules identified as an integral part of the financial statements.

30. Information contained in these statements is grouped into broad classes according to economic characteristics. These broad classes are termed the "elements" of financial statements. In so far as the balance sheet and income statement are concerned, these elements include assets, liabilities, equity, revenue and expenses. An element in a financial statement may comprise one or more items of information. Each item relates to transactions or events that have to be recognized, measured, accumulated and summarized. A more complete discussion of financial statements and their elements can be found in chapter IV.

B. Recognition and measurement methods

1. Recognition

31. Recognition is the process of formally incorporating an item into a financial statement. It involves the description of an item both qualitatively and quantitatively and its inclusion in the total amount of the element to which it belongs. 9/

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32. An item should be recognized in a financial statement if: 10/

(a) It can be measured with sufficient reliability and the amount involved can be reasonably estimated;

(b) It is probable that economic resources or any future economic benefits associated with that item will be obtained or given up;

(c) The information provided is capable of influencing users' decisions.

33. Among the concepts that underlie the recognition and measurement elements of information in financial statements are "going concern" and "accrual accounting".

(a) Going concern. In recognizing and measuring the effect of transactions and events to create items of information, and in the absence of evidence to the contrary, an enterprise is normally regarded as a "going concern", that is, as continuing in operation for the foreseeable future. That is, the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operation. This assumption should not preclude the reflection of economic realities, such as changes in the value of economic resources in financial statements. Such changes cannot be ignored without injustice to the many investors who are moving in and out as shareholders of an enterprise.

(b) Accrual accounting. Transactions and events are recognized in the balance sheet and income statement as part of elements of information when they occur, not when money is received or paid, and they are reported for the periods in which they take place.

Although these concepts are not usually mentioned in financial statements, an explanation should be given when they are not followed.

2. Measurement

34. Measurement is the process of determining the monetary value to be given to an item included in a financial statement. To assign a monetary value to an item, one needs to select a unit of measurement and the method by which the item is to be valued.

35. Monetary values are normally expressed in nominal monetary units that are not adjusted for changes in purchasing power. Under highly inflationary conditions, it is appropriate to express monetary values in constant purchasing power units or inflation-adjusted units (nominal monetary units adjusted by a general index reflecting changes in purchasing power).

36. Methods of measurement include the following: 11/

(a) Historical cost refers to the measurement of the value of an item on the basis of initial cash or cash equivalent paid or incurred (or received) at its acquisition or self-generation (or in consideration of an obligation);

(b) Replacement cost refers to measurement of the cash or cash equivalent that would have to be paid at the current time if the item were to be replaced. This may be the cost of reproducing the asset (that is, replacement of a physical object) or the cost of providing equivalent services;

(c) Net realizable value is the amount of cash or cash equivalent by which an item can be exchanged in the market in the normal course of business, that is, selling price less selling costs. This method provides a measure of what an enterprise would lose by not selling an item;

(d) Present value is the discounted value of the future cash or cash equivalent flow that an item is expected to generate in the normal course of business.

37. Historical cost has been the method most commonly used by enterprises in preparing financial statements. Because this method cannot cope with the effects of changing prices, enterprises operating in highly inflationary economies have frequently adopted constant purchasing power or some other means of adjusting for inflation. When using the historical cost method, a different basis of measurement is often used for specific financial statement items. For example, inventories are normally carried at their realizable value if it is lower than cost; marketable securities are often carried at their realizable value; and, in some jurisdictions, properties and certain other fixed assets may be periodically restated to their market value.

C. Capital and capital maintenance

38. The financial resources of an enterprise are sometimes described as capital. It is generally accepted that an enterprise has realized income for a period only if its capital has been maintained. It is therefore important to know what is meant by capital maintenance. First of all, a distinction must be made between capital maintenance in the legal sense and capital maintenance in accounting theory.

39. Capital maintenance in the legal sense is particularly relevant for those enterprises that have adopted the legal form of a limited liability company. For such enterprises capital is the amount contributed by the shareholders to the company's resources. The amount contributed to the company becomes the company's property forthwith. In order to protect third parties dealing with the company, this amount must be maintained at all times, except for cases of reductions of subscribed capital. Distributions to shareholders may not be made out of capital or out of those reserves that must be maintained by law or statute.

40. In discussing capital maintenance, accounting literature recognizes two concepts: financial capital, and physical capital or operating capability.

41. Under the first concept, it is assumed that capital has been maintained if owners' equity at the end of a period, exclusive of contributions by and distributions to owners during the period, is at least the same as it was at the beginning of the period. Financial capital maintenance can be measured in either

nominal monetary units or units of constant purchasing power. When capital is defined in terms of nominal monetary units, any increase in the prices of assets held over the period conceptually is income. The increase may not be recognized as such, however, until realization. When capital is defined in terms of constant purchasing power, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as income.

42. Under the second concept, it is assumed that capital has been maintained if an enterprise has as much operating capability, or productive capacity, at the end of the period as it had at the beginning. Income represents the increase in the physical productive capacity over the period. All price changes affecting the enterprise's assets and liabilities are viewed as changes in the measurement of the physical productive capacity of the enterprise.

43. The distinction between financial capital maintenance and physical capital maintenance can be illustrated by the following analogy. If a profit-making enterprise is compared with an orchard of fruit trees, the fruit represents income, although it is not generally regarded as being realized until the fruit has been picked. Soil conditions, weather and other factors will affect annual yields, but a clear distinction will always be made between the fruit (income) and the trees (capital) from which it is derived. Looked at from the perspective of financial capital maintenance, any increase in the monetary value of the orchard might well be regarded as income. Looked at from the point of view of the orchard as an operating entity, the productive capacity of the trees in the orchard must be conserved before any income can be deemed to be earned. 12/

44. The concept of capital maintenance provides the linkage between the concept of capital and the concept of profit because it provides the bench-mark by which profit is measured. Although most financial statements use the nominal financial capital maintenance concept, it is not necessary or even possible to decide for all users which concept is preferable. That depends to a large extent upon the user's interests and needs.

IV. FINANCIAL STATEMENTS AND THEIR ELEMENTS

A. Balance sheet

45. The position of the enterprise is presented in the balance sheet. That statement shows resources and the claims to or interests in them and provides an indication of the financial strength of the enterprise. It should assist the user in judging the ability of the enterprise to meet its obligations.

46. The resources of the enterprise are referred to as its assets, and these give some indication of its potential to generate future resources. Claims against resources are referred to as liabilities. The difference between assets and liabilities, being the interests of the owners, is referred to as equity. Equity arises from two sources: paid-in capital, i.e., the funds provided by shareholders, and retained earnings, i.e., the funds generated by the enterprise's activities less distributions to shareholders. The paid-in capital and retained

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earnings are referred to as owners' equity because, in the final analysis, the residual claim on resources belongs to shareholders.

47. The balance sheet thus includes the following elements:

(a) Assets, which are resources controlled by the reporting enterprise as a result of past events and from which future benefits are expected to flow to the enterprise;

(b) Liabilities, which are obligations of the reporting enterprise that have arisen from past events and the settlement of which is expected to result in outflows of resources embodying economic benefits;

(c) Equity, which is a residual arising from the deduction of liabilities from the assets of the reporting enterprise. It can be separated into that which the enterprise receives from shareholders and that which it generates through its own efforts and distributes to shareholders or uses for future operations:

(i) Paid-in capital is the amount provided by the shareholders (including any amounts transferred from retained earnings);

(ii) Retained earnings are the accumulated income generated over time by the reporting enterprise's activities after deducting the amount distributed (in cash and shares).

48. In addition, in current practice, certain items that do not satisfy the definition of an asset or a liability and that are not shown as part of equity (for example, deferred charges and deferred credits) are disclosed separately in the statement.

1. Assets

49. The future economic benefit embodied in an asset may flow in a number of ways. An asset may be: 13/

(a) Used independently or jointly with other assets to produce goods and services to be sold by the enterprise;

(b) Exchanged for other assets;

(c) Used to settle one or more obligations;

(d) Distributed to the owners of the enterprise.

50. Assets include property, plant and equipment; financial leases; investments in subsidiaries and other enterprises; long-term receivables; purchased goodwill, patents, trade marks and similar intangibles; marketable securities; current receivables (or trade debts); inventories; cash and bank balances; and prepaid expenses.

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51. Assets arise from events in the past. These events may be cash or non-cash transactions. Assets may be purchased, exchanged for other assets, self-generated or received as grants or donations.

2. Recognition of assets

52. An asset is recognized when it is reasonably certain that the future economic benefit embodied in it will flow to the enterprise and it satisfies the other conditions for the recognition of an item set out in paragraph 32. It is not enough that an item of expenditure is incurred. The expenditure must be followed by a reasonable expectation of future economic benefit. If such a degree of certainty does not exist, the expenditure is treated as an expense, not an asset.

53. In a number of countries, intangible assets such as concessions, patents, licences, trade marks and similar rights and assets may be recognized in the balance sheet only if they were acquired for a valuable consideration. A number of countries allow assets to be carried on the balance sheet only if the reporting enterprise is the legal owner.

3. Liabilities

54. Settlement of a liability may occur in a number of ways: 14/

(a) Payment of cash;

(b) Transfer of other assets;

(c) Provision of services;

(d) Replacement of the obligation with another obligation;

(e) Conversion of the obligation into equity capital.

55. Liabilities include long-term loans and debentures, short-term loans, and bank overdrafts, payables, provisions, pension plans and similar financial commitments. The scope of the definition of liabilities in this report covers obligations whose financial amounts can or cannot be established precisely. It therefore covers what are usually described as provisions in some countries. Provisions are liabilities, the amount of which cannot be established precisely, or the occurrence of which is uncertain. In some countries, provisions may not be used to adjust the value of assets. In those countries, value adjustments on debtors are referred to as write-downs. In other countries, write-downs on debtors are commonly referred to as provisions. Provisions should be distinguished from reserves, which are amounts set aside under equity for future use with respect to obligations that may arise from probable or possible events, the occurrence of which the enterprise is not yet aware.

4. Recognition of liabilities

56. A liability is recognized when it is reasonably certain that a future reduction in economic benefit will result from the settlement of the obligation and it satisfies the other conditions cited in paragraph 32 for the recognition of an item.

5. Equity

57. Equity is defined in paragraph 47 (c) as a residual arising from the deduction of liabilities from the assets of the reporting enterprise. This amount may differ from the aggregate value of the enterprise's shares on the stock market or from the sum that may be realized by the sale of the enterprise as a going concern or by the sale of its net assets on a piecemeal basis. 15/

58. Equity is better understood when it is disaggregated into (a) that which it receives from shareholders and (b) that which the reporting enterprise generates by its own efforts. There are extensive legal requirements in many countries dealing with equity. Many of these requirements affect the classification of equity into that which is available for distribution and that which can be distributed only if certain conditions are met.

59. Legal or statutory reserves are specified by statute law or by articles of association of the enterprise to provide a measure of protection against future losses.

60. Paid-in capital is treated differently in many countries. In some countries, all amounts paid in by equity shareholders are classified as paid-in and are not further categorized. In other countries, paid-in capital is divisible into two types: that relating to the par value of the shares offered for sale and that relating to share premium or additional capital. In consolidated balance sheets, the amount of equity should be given separately for the shareholders of the parent enterprise and for other shareholders.

61. Retained earnings or reserves may be categorized in a number of ways, as the practice of many countries seems to confirm. These categories include:

(a) Capital, including revaluations, versus revenue reserves;

(b) Legal/statutory versus non-statutory reserves;

(c) Distributable versus non-distributable reserves;

(d) Specific versus general reserves.

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B. Income statement/profit and loss statement

62. The income statement or profit and loss statement measures the performance of an enterprise. The bottom line of this statement is the net result of the operations of the enterprise in the reporting period. It reveals the change during the period in the equity of the enterprise resulting from its operations.

63. The elements of the income statement reflect the inflows and outflows of financial resources that have contributed to the income for the period. Inflows are referred to as revenues, and outflows are referred to as expenses. Revenues and expenses are terms used to refer to the ordinary business activities of an enterprise.

64. There are different treatments for transactions outside the ordinary course of business, such as changes in prices of resources held by an enterprise at the end of a reporting period. If such changes suggest increases in equity, they are referred to as holding gains; if they suggest decreases, they are referred to as holding losses. The treatment of such gains and losses depends on the concept of capital maintenance adopted by the reporting enterprise. Under the financial capital maintenance concept, gains and losses are either (a) included in the income statement (although their recognition may be delayed until the item is disposed of or settled), or (b) treated as part of the adjustment necessary to maintain capital (and thus excluded from income) to the extent that they correspond to changes in the general price level, any excess or deficiency being treated as a gain or loss to be reflected in income. Under the physical capital maintenance concept, all price changes are treated as affecting the measurement of the reporting enterprise's productive capacity and as adjustments to capital rather than to income. 16/

65. The income statement thus includes the following elements:

(a) Revenues are inflows or enhancements of assets (or reductions of liabilities) that arise in the course of the enterprise's normal activities;

(b) Expenses are outflows or depletions of assets (or additions to liabilities) that arise in the course of the enterprise's normal activities;

(c) Gains are increases in equity that result from transactions that are incidental to the enterprise's activities and from other transactions, events or circumstances affecting the enterprise during a period, except those that result in revenues or equity contributions;

(d) Losses are decreases in equity that result from transactions that are incidental to the enterprise's activities and from other transactions, events or circumstances affecting the enterprise during a period, except those that result in expenses or distributions of equity.

66. Although revenues and gains are similar, as are expenses and losses, there are some significant differences in the information conveyed to users about an enterprise's performance. Revenues and expenses result from an enterprise's

ongoing primary operations and activities. In contrast, gains and losses result from incidental transactions and from other events and circumstances affecting the enterprise. Revenues and expenses are normally displayed as gross inflows or outflows of economic resources, whereas gains and losses are normally displayed as net inflows or net outflows.

67. The income statement includes sales, operating results, interest and investment income, share in the net income (loss) of associated enterprises, non-operating gains and losses, interest expense, depreciation, depletion and amortization, taxes on income, unusual charges and credits, leasing expenses, gain or loss relating to transactions in and translation of foreign currencies, amount of used or sold inventories, employment costs, net income and research and development.

68. There should be a separate statement providing information relating to the allocation of net income (or profits) for the period.

1. Revenues

69. The events that result in revenues and revenues themselves are referred to by a variety of names, including sales, fees, interest, dividends, royalties and rent.

2. Recognition of revenues 17/

70. Revenues are an important component in the calculation of earnings as reflected in the formula: Revenues - Expenses + Gains - Losses = Earnings. The recognition of revenues on a consistent and appropriate basis is fundamental to the preparation of the income statement.

71. There can be uncertainties affecting the recognition of revenue, as in the following cases:

(a) The consideration receivable cannot be determined within reasonable limits;

(b) Costs to be incurred in producing or purchasing goods or services cannot be reasonably determined;

(c) The collectability of the receivable resulting from a sales transaction is uncertain;

(d) There is uncertainty regarding the amounts of returnable goods.

72. Revenue should be earned as well as realized, or be clearly capable of realization, before it is recognized. Revenue is considered to have been earned when the requirements concerning performance are satisfied and collection of the invoice amount is reasonably assured. Revenue is realized when goods or services are exchanged for cash or claims to cash.

73. The following items should be disclosed:

(a) Revenues derived from the sale of goods, the rendering of services, and the use by others of enterprise resources yielding interest, royalties and dividends;

(b) Accounting policies describing the method or methods used in recognizing revenue.

3. Expenses

74. The events from which expenses arise and expenses themselves are referred to by a variety of names, including cost of sales, wages and depreciation. As in the case of revenue, they all share the same essential characteristics.

4. Recognition of expenses

75. An expense is recognized when it is realized that an expenditure will not produce future economic benefits. It is also recognized when a liability is incurred without the recognition of an asset, for instance, when a liability for taxation arises. 18/

5. Gains and losses

76. Gains and losses are not all alike. There are several kinds, even in a single enterprise. They may be described or classified according to sources. Some gains or losses are the net result of deducting the amount of resources originally used to obtain the item concerned from the proceeds received on its disposition (for example, sales of marketable securities, dispositions of used equipment). Some result from non-reciprocal transfers (for example, gifts, amounts received or paid pursuant to a lawsuit). Other gains or losses result from holding assets or liabilities while their values change (for example, inventory items written down from cost to market). Yet others result from environmental factors (for example, flood and earthquake damage or destruction). Gains and losses may also be described or classified as "operating" or "extraordinary/unusual", depending on their relationship to the enterprise's central activities. 19/

6. Recognition of gains and losses

77. Gains are normally recognized when realized. Losses are normally recognized when realized or when it becomes evident that there is an impairment in the value of the assets, or an increase in the liabilities, to which the losses relate.

C. Statement of changes in financial position 20/

78. The statement of changes in financial position conveys information about the changes in the funds of the enterprise. It reflects the flow of funds and the uses of such funds, depicting the investing and financing activities of the enterprise. It distinguishes between the funds that are generated by the enterprise and those that are provided from outside the enterprise. It is also capable of providing information that is not readily available from the profit and loss statement and the balance sheet, including:

(a) Whether profitability has been accompanied by sufficient cash flow to meet liquidity needs, both for maintenance of operations and for expansion;

(b) Investment or divestment in subsidiaries, in associated companies and in fixed assets, and working capital.

79. The purpose of the statement is to summarize the flow of funds during a period, showing information about financial resources provided from operations and other sources and the uses made of those financial resources. The statement should show separately significant elements of internally generated funds and funds obtained from external sources, and the uses to which those funds have been put. The statement may also include other items that do not directly affect cash or working capital.

D. Statement of allocation of net profits or net income or statement of retained earnings 21/

80. This statement should disclose the following elements:

(a) The balance of retained income brought forward from the previous year;

(b) The net income of the current year;

(c) Transfers to and from other reserves (including those required by national legislation);

(d) Dividends or similar distribution to the owners of the enterprise or group (subdivided by type);

(e) Any part of the net income payable to members of the board or others;

(f) The balance retained and carried forward to the next year.

81. The attribution of a current year's loss should be accounted for in a similar way.

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V. OUTLINES OF FINANCIAL STATEMENTS

A. Balance sheet

Assets		Liabilities
Deferred charges		Deferred credits
		Equity
Total	=	Total

B. Income/profit and loss statement

\+ Revenues

\+ Gains

\- Expenses

\- Losses

Net income/profit or loss for the period

C. Statement of retained earnings

Opening retained earnings

± Net income/profit or loss for the period

± Dividends to shareholders

± Transfers to other reserves

Closing retained earnings

D. Equity

Opening equity

\+ Closing retained earnings

± Contributions by and distributions to shareholders

Closing equity

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Notes

1/ Conclusions on Accounting and Reporting by Transnational Corporations, report of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (United Nations publication, Sales No. E.88.II.A.18) (forthcoming) para. 24.

2/ Ibid., para. 23.

3/ International Accounting Standard 1, Disclosure of Accounting Policies, January 1975, para. 9 (c).

4/ International Accounting Standards Committee (IASC), Exposure Draft, Proposed Statement: Framework for the Preparation and Presentation of Financial Statements, 1 May 1988, para. 31.

5/ Conclusions ..., para. 75 (f).

6/ Accounting Standards Committee (Canada), Financial Statements Concepts, 28 September 1988, Section 1000, para. 18 (b).

7/ Conclusions ..., para. 27.

8/ Ibid., para. 29.

9/ IASC, Exposure Draft, para. 80.

10/ Ibid., para. 81.

11/ Ibid., paras. 98-99.

12/ Canadian Institute of Chartered Accountants, Corporate Reporting: Its Future Evolution, 1980, p. 17.

13/ IASC, para. 55.

14/ Ibid., para. 62.

15/ Ibid., para. 67.

16/ Ibid., para. 107.

17/ Conclusions ..., paras. 40-43.

18/ IASC, para. 96.

Notes (continued)

19/ Financial Accounting Standards Board (United States), Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, December 1985, paras. 85-86.

20/ Conclusions ..., paras. 151-152.

21/ Ibid., paras. 148-149.

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