



FOURTEENTH EDITION

COMPARATIVE INTERNATIONAL ACCOUNTING

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not be treated symmetrically. Hellman (2008) examined conservatism in the context of IFRS and suggested that the requirements of IASs 11, 12 and 38 (on contracts, deferred tax and development costs) involve temporarily less conservatism than under some European practices.

6.2.3 Enhancing qualitative characteristics

Comparability, including consistency

Financial information is unlikely to be relevant unless it can be compared across periods and across companies. This requires as much consistency as possible in the use of methods of measuring and presenting numbers; it requires also that any changes in these methods should be disclosed.

Verifiability

This means that different observers should be able to come to approximately the same view about whether a faithful representation is being given by the information. So, information must be able to be checked in various ways.

Timeliness

Relevance is increased if information is up to date. This raises a common problem that there may be an inconsistency between concepts. For example, the need to ensure reliability of information may slow down its publication. The regulators of financial reporting in many countries set time limits for the publication of financial statements and require reporting more than once a year.

Understandability

Clearly, information cannot be relevant unless it can be understood. However, in a complex world, information may have to be complex to achieve a fair presentation. The rule-makers and preparers are allowed to assume that the important users are educated and intelligent.

6.2.4 Elements of financial statements

Chapter 4 of the *Framework* examines the five ‘elements’ of financial statements. Accounting could, in principle, work in one of two ways:

Method 1

- *Expenses* of 20X1 are the costs of any period that relate to 20X1; and therefore . . .
- *Assets* at the end of 20X1 are any remaining debits.
- This would fit well with the accrual basis, and with the related concept of matching costs with revenues in a period.

Method 2

- *Assets* at the end of 20X1 are the controlled resources that can give future benefits; and therefore . . .
- *Expenses* of 20X1 are any remaining debits.

The IASB *Framework* gives primacy to Method 2, by starting with an asset defined as follows (paragraphs 4.3 and 4.4):

An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits

This has the effect of reducing the importance of the matching concept, as noted above. If an expense is postponed in order to match it against a future income, it would have to be stored in the balance sheet as an asset. However, this is not allowed under IFRS unless the amount meets the definition of an asset. This restriction on the items to be shown as assets does not come from a desire to be prudent but from a desire to comply with a coherent framework. Note that the definition does not now say that benefits are ‘expected’, which was the case until 2018. This confirms that items can be assets even if an inflow is less than probable.

The IASB gives similar importance to the definition of ‘liability’. According to the *Framework*: (paragraphs 4.26):

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

The 2018 *Framework* makes it clear that the obligation to transfer resources to a third party does not have to be completely unavoidable. Rather, the entity must have ‘no practical ability’ to avoid the outflow. Many liabilities are clear legal obligations of exact amounts, such as accounts payable or loans from the bank. Some liabilities are of uncertain timing or amount. These are called ‘provisions’. Depending on the nature of legal contracts, some of these provisions are also legally enforceable, such as provisions to pay pensions to retired employees, or to repair machinery sold to customers that breaks down soon after sale. Some obligations are not based on precise laws or legal contracts but would probably be enforced by a court of law, based on normal business practices or, at least, the enterprise would suffer so much commercial damage if it did not settle the obligation that it cannot reasonably avoid settling it. These ‘constructive obligations’ are included in the concept.

‘Equity’ is the word used for the residual interest in the entity, as calculated by deducting the liabilities from the assets. So, equity is not independently defined. Similarly, the definitions of income and expenses derive from those of assets and liabilities:

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

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

However, Barker (2010) has pointed out that these definitions are the wrong way round. That is, an increase in an asset is a *debit*, whereas income is a *credit*. So, income should be defined as an increase in equity resulting from an increase in an asset, and so on. Other comprehensive income (OCI) is not defined as a separate element. However, later, Chapter 7 suggests that profit or loss is a measure of the performance of the year, and that income should be included in it unless it has special features, including being related to the remeasurement of assets or liabilities.

Chapter 5 of the *Framework* discusses the issue of recognition. Not all items that meet the definitions of asset or liability are recognised. This might be caused by

improbability of inflows, high uncertainty of measurement or excessive cost. However, an important change from the original *Framework* of 1989 is that there is no recognition *requirement* that the flows should be ‘probable’. Indeed, despite the old *Framework*, derivative financial instruments were recognised under IAS 39 (as now under IFRS 9) even if no flows were probable. The change in the *Framework* might affect future standard setting, potentially widening recognition.

6.2.5 Measurement

Chapter 6 of the *Framework* deals with the measurement of assets and liabilities. It sets out the different possible measurement bases, principally historical cost or current measures. The latter include fair value (the current market price), value in use (discounted cash flows) and current cost (the replacement cost of the asset). The *Framework* provides some guidance on how to choose a measurement basis, including consideration of how an item will affect future cash flows. It is clear that the IASB intends to continue using different measurement bases for different assets and liabilities; and the vague guidance of the 2018 *Framework* is unlikely to constrain this variety. In Chapter 7 of this book, we look at which bases the standards require or allow for the measurement of various assets and liabilities.

6.2.6 Presentation

Chapter 7 of the *Framework* deals with presentation and disclosure. The most interesting section discusses the splitting of the income statement into two parts: profit or loss, and other comprehensive income. Accounting practice on this topic had gradually arisen after the original *Framework* of 1989. The 2018 revision struggles to make sense of this retrospectively. It suggests that profit or loss is the primary source of information about an entity’s financial performance for the reporting period (paragraph 7.22).

There is then the admission that sometimes (for no very clear reason) some gains and losses are not shown in profit or loss. However, at least this category is constrained by the requirement that it can only include items related to a current value measurement basis. The requirements of IFRS on this issue are examined in Section 6.3.

6.3 IFRS requirements on presentation and accounting policies

6.3.1 Concepts and formats in IAS 1

IAS 1 (*Presentation of financial statements*) turns some of the *Framework*’s ideas into requirements. For example, the going concern concept and consistency are dealt with. The overall requirement is for a fair presentation, and this includes the instruction to depart from standards where necessary to achieve such a fair presentation. A similar ‘override’ is found in the EU Fourth Directive and the resulting national laws (see Chapter 15). IAS 1 requires a numerical reconciliation from any basis that departs from any standard to the basis required in that standard. It had been widely assumed that the

override would not be used in IFRS practice. However, a high-profile use was that by the French bank, Société Générale, in order to show a large loss of 2008 caused by a 'rogue trader' in its 2007 income statement. This is examined in more detail by Nobes (2009).

IAS 1 requires an entity to present four financial statements. First, there is the statement of financial position, often called a balance sheet in practice. In this book, we use the two terms interchangeably. If there have been any restatements (e.g. due to policy changes or error corrections), then an opening balance sheet for the earliest period presented must also be shown. If figures for two years are normally shown (the minimum required by IAS 1), this would mean that three balance sheets would be shown when there had been restatements.

Unlike some national laws (see Chapter 16), IAS 1 does not set out standard formats for financial statements. However, it does give a minimum list of headings to be shown on financial statements. In the balance sheet, a split between current and non-current items is required, unless a presentation in liquidity order without such a split would be more appropriate (e.g. in a financial institution). The term 'current' is defined widely to include both realisation within one year or realisation within the entity's operating cycle.

IFRS 5 requires an entity to identify separately any formerly non-current assets that are now intended for sale within a year, and to show them on the balance sheet under the heading 'held for sale'. Where a major line of business is to be sold within the coming year or has been sold in the past year, its revenues and expenses should also be separated out and shown as 'discontinued operations' in the statement of comprehensive income. This is designed to help the users to predict future cash flows.

6.3.2 Comprehensive income

The next requirement in IAS 1 is for a statement of profit or loss and other comprehensive income (SPLOCI). This must include all items of income and expense, including revaluations. There must be no reserve movements; no gains and losses go directly to equity. However, some gains and losses (e.g. some revaluations and some foreign currency gains and losses) have traditionally been presented separately in IFRS and in national accounting systems. IAS 1 preserves this idea because these items are shown at the bottom of the SPLOCI as 'other comprehensive income'. The total *excluding* these amounts is shown as the 'profit or loss'. The technical term 'earnings' (see Section 6.5) also excludes these amounts. IAS 1 allows an entity to show a separate 'income statement' section, containing only the elements of profit or loss.

Unfortunately, there is no clear principle in the *Framework* to explain why some gains and losses are 'profit or loss' and some are not. Beginning in the UK in 1993 (with FRS 3), standard-setters had gradually required that all gains and losses should be recorded in a primary statement of income rather than any of them being lost as 'reserve movements'. The UK statement was called a 'statement of total recognised gains and losses' (STRGL), which included the profit from the bottom of the 'profit and loss account' and then all other gains and losses. These latter are now called 'other comprehensive income' (OCI) in IFRS and in US GAAP and, from 2013, they must be included in the SPLOCI, which can be (and nearly always is) split into an income statement and OCI. In US GAAP, the amounts of OCI could, until 2013, be included in the statement of changes in equity, and this was the most common practice, as shown in

Table 6.3 Reporting of OCI (US companies), 2009

	% of companies
Included in statement of changes in equity	81.0
Separate statement of comprehensive income	15.2
Combined statement of income and comprehensive income	2.2
No comprehensive income shown	1.6
	100.0

Source: American Institute of Certified Public Accountants (AICPA) (2010) *Accounting Trends and Techniques*. AICPA, Jersey City, New Jersey, p. 425.

Table 6.3 for 500 US companies in 2009. Bamber *et al.* (2010) suggest some reasons for this, related to avoiding volatility of earnings.

IAS 1 does not explain which gains and losses are taken to OCI. This changes from time to time, and one must read all the other standards to find out. Under IFRS in 2020, the components of OCI are:

- fair value adjustments of PPE and intangible assets (under IASs 16 and 38; see Chapter 7);
- fair value adjustments on some financial assets (under IFRS 9; see Chapter 7);
- gains and losses on cash flow hedges (under IFRS 9; see Chapter 7);
- pension remeasurement gains and losses (under IAS 19; see Chapter 7); and
- foreign currency gains and losses on the translation of financial statements (under IAS 21; see Chapter 17).

All of these, apart from the first, are also relevant under US GAAP. IAS 1 requires an entity to show the tax related to each component of OCI.

All the above components meet the definitions of ‘income’ or ‘expense’. The explanation for exclusion from profit or loss is *not* that they are ‘unrealised’, because gains on unsold investment properties or forests *are* included in profit or loss under IASs 40 and 41. Anyway, the concept of ‘realised’ does not appear in IFRS, and its meaning is unclear in EU laws. The issue is important because ‘earnings’ (as in earnings per share or the price/earnings ratio) is calculated before any items of OCI.

A related issue is whether gains and losses, once recorded in OCI, are ever reclassified as profit or loss. A summary of the answers to this question is shown as Table 6.4. It reveals another set of rules for which no principle can be discovered; and it reveals different answers for IFRS and US GAAP. The historical political explanation for the mixed answer under IFRS is that standards influenced by the US require reclassification, whereas those influenced by the UK do not. Both IFRS and US GAAP require companies to show which parts of the year’s OCI will later be potentially reclassified as profit or loss, and to show any amounts reclassified in the year.

Clearly, this issue needs to be settled by the standard-setters, but despite large numbers of working parties from the late 1990s onwards, no conclusion has been reached even in the joint FASB/IASB *Preliminary Views on Financial Statement Presentation* (IASB, 2008). The IASB’s revised conceptual framework of 2018 suggests that

Table 6.4 Are gains or losses that were previously recorded as OCI later reclassified as profit or loss?

	US	IFRS
Revaluation of equity financial assets	N/A	No
Revaluation of other financial assets	Yes	Yes
Cash flow hedges	Yes	Yes
Revaluation of tangible assets	N/A	No
Translation of foreign statements	Yes	Yes
Actuarial gains/losses	Yes	No

N/A = Not applicable because practice not allowed.
Source: prepared by the author.

elements of OCI should generally later be reclassified, which suggests a possible gradual move of IFRS towards the US position.

6.3.3 Other statements

After the SPLOCI, there is a statement of changes in equity (SCE) which shows all changes in equity in the period. These will be of three types:

- 1 comprehensive income (from the SPLOCI);
- 2 effects of restatements (i.e. any policy changes or corrections of errors);
- 3 transactions with owners (e.g. share issues or dividend payments).

Lastly, IAS 7 requires the presentation of a statement of cash flows, which classifies cash flows into operating, investing and financing flows. The total flow then reconciles to the period's change in the total of cash and cash equivalents. Like US GAAP, IAS 7 allows operating cash flows to be calculated either directly or indirectly by adjusting profit for non-cash items such as depreciation. However, unlike US GAAP, IAS 7 allows choices of position for dividends and interest paid and received.

6.3.4 Accounting policies

IAS 8 (*Accounting policies, changes in accounting estimates and errors*) deals with the choice of accounting policies and how to account for changes in them. Some standards give companies choices (e.g. measurement at cost or fair value for some assets; see Chapter 7). On some topics, there are no instructions in IFRS, so a suitable accounting policy must be created by the company. IAS 8 allows a change of policy to one that gives more relevant information. The *Framework* should be used to help policy choice or creation. Nobes and Stadler (2015) study 434 policy changes by companies of 10 countries in the period 2006 to 2011, finding that most are explained using qualitative characteristics from the *Framework*, particularly increased comparability.

IAS 8 also covers changes of estimate, such as revising the depreciable life of a machine. These are common and are absorbed into current and future financial