Statement of Accounting Concepts **SAC 4**
(3/95)

Definition and Recognition of the Elements of Financial Statements

Prepared by the **Public Sector Accounting Standards Board** of the **Australian Accounting Research Foundation** and by the **Australian Accounting Standards Board**

Issued by the **Australian Accounting Research Foundation** on behalf of **The Institute of Chartered Accountants in Australia** and the **Australian Society of Certified Practising Accountants** and by the **Australian Accounting Standards Board**

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ISSN 1035-3631

INTRODUCTORY NOTE

This Introductory Note explains the purpose of this Statement and summarises the primary concepts set out therein, to assist those who wish to obtain an overview of those concepts. It is important to note that a full appreciation of the concepts and their implications can be obtained only when the concepts are read in the context of the related commentary. The background to the development of this Statement and the basis for the conclusions reflected therein are outlined in the attachment to the Statement.

The Conceptual Framework

The Statement forms part of the conceptual framework for general purpose financial reporting in the private and public sectors which is being developed by the Australian Accounting Standards Board (AASB) and by the Public Sector Accounting Standards Board (PSASB) of the Australian Accounting Research Foundation. The framework will comprise a series of Statements of Accounting Concepts which set out the concepts which have been adopted by the AASB and PSASB in respect of the nature, subject, purpose and broad content of general purpose financial reporting. The policy of the Boards regarding the nature and purpose of Statements of Accounting Concepts is set out in Policy Statement 5 "The Nature and Purpose of Statements of Accounting Concepts".

Purpose of this Statement

The purpose of this Statement is to establish definitions of the elements of financial statements (namely assets, liabilities, equity, revenues and expenses) and to specify criteria for their recognition in financial statements.

Summary of Concepts

Definition of Assets

"Assets" are future economic benefits controlled by the entity as a result of past transactions or other past events.

Criteria for Recognition of Assets

An asset should be recognised in the statement of financial position when and only when:

(a) it is probable that the future economic benefits embodied in the asset will eventuate; and

(b) the asset possesses a cost or other value that can be measured reliably.

Definition of Liabilities

"Liabilities" are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events.

Criteria for Recognition of Liabilities

A liability should be recognised in the statement of financial position when and only when:

(a) it is probable that the future sacrifice of economic benefits will be required; and

(b) the amount of the liability can be measured reliably.

Definition of Equity

"Equity" is the residual interest in the assets of the entity after deduction of its liabilities.

Definition of Revenues

"Revenues" are inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the reporting period.

Criteria for Recognition of Revenues

A revenue should be recognised in the operating statement, in the determination of the result for the reporting period, when and only when:

(a) it is probable that the inflow or other enhancement or saving in outflows of future economic benefits has occurred; and

(b) the inflow or other enhancement or saving in outflows of future economic benefits can be measured reliably.

Definition of Expenses

"Expenses" are consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the reporting period.

Criteria for Recognition of Expenses

An expense should be recognised in the operating statement, in the determination of the result for the reporting period, when and only when:

(a) it is probable that the consumption or loss of future economic benefits resulting in a reduction in assets and/or an increase in liabilities has occurred; and

(b) the consumption or loss of future economic benefits can be measured reliably.

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STATEMENT OF ACCOUNTING CONCEPTS

SAC 4 "DEFINITION AND RECOGNITION OF THE ELEMENTS OF FINANCIAL STATEMENTS"

GENERAL

Reissued Statement

1 This Statement supersedes Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements" as issued in March 1992.

Accounting Concepts and Commentary

2 The accounting concepts set out in this Statement are shown in bold print. Commentary to those concepts is shown in normal print immediately after the accounting concepts to which it relates, as an aid to the interpretation of those concepts.

Nature and Purpose of Statements of Accounting Concepts

3 The nature and purpose of Statements of Accounting Concepts are set out in Policy Statement 5 "The Nature and Purpose of Statements of Accounting Concepts", prepared by the Australian Accounting Standards Board (AASB) and the Public Sector Accounting Standards Board (PSASB) and issued in March 1995. Policy Statement 5 states that Statements of Accounting Concepts set out the concepts which have been adopted by the Boards in respect of the nature, subject, purpose and broad content of general purpose financial reporting.

4 Consistent with the role of Statements of Accounting Concepts enunciated in Policy Statement 5, the primary purpose of this Statement is as a guide to the AASB and PSASB in developing and reviewing Accounting Standards and other authoritative documents. In addition, this Statement may also provide guidance in analysing new or emerging issues in the absence of applicable Accounting Standards.

Status of Statements of Accounting Concepts

5 The concepts in this Statement are not set out as requirements for the purpose of preparing general purpose financial reports. This is consistent with the purpose of Statements of Accounting Concepts set out in Policy Statement 5, and the non-mandatory status of Statements of Accounting Concepts under Professional Statement APS 1 "Conformity with Accounting Standards" and the Corporations Law. Policy Statement 5 also notes that some Statements of Accounting Concepts have been given legislative backing in respect of some reporting entities in the public and private sectors through requirements specified in legislation, ministerial directives or other government authority. The level of authority given to Statements of Accounting Concepts by governments and other authorities is a matter for those authorities to determine.

INTRODUCTION

6 Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting" identifies the objective of general purpose financial reporting as the provision of information which is useful to users for making and evaluating decisions about the allocation of scarce resources and which assists in discharging the accountability of the entity's management or governing body. Such decision making is likely to involve users of the entity's general purpose financial reports assessing its performance, financial position, financing and investing, and compliance. Information about the entity's assets, liabilities, equity, revenues and expenses (the elements of financial statements) is relevant to users in assessing these aspects.

Purpose of this Statement

7 This Statement establishes definitions of the elements of financial statements and specifies criteria for their recognition that are consistent with the objective of general purpose financial reporting set out in SAC 2. These definitions and recognition criteria are also consistent with the qualitative characteristics set out in Statement of Accounting Concepts SAC 3 "Qualitative Characteristics of Financial Information".

8 This Statement does not address in detail the measurement or display of the elements of financial statements or concepts of capital and

profit. These issues will be the subject of separate Statements of Accounting Concepts.

Definitions and Recognition Criteria

9 The definitions of the elements of financial statements set out in this Statement identify the essential characteristics of those elements. The recognition criteria set out in this Statement specify the conditions under which an item which satisfies the definition of an element should be recognised (or included) in financial statements. Satisfying the definition of an element is a necessary but not sufficient condition for an item to be recognised in financial statements. Accordingly, there is no need to consider whether an item satisfies the recognition criteria if it does not meet the definition of an element. For example, if the definition of liabilities in paragraph 48 and the criteria for recognition of liabilities in paragraph 65 are applied, there is no need to consider whether it is probable that a particular sacrifice of economic benefits will be required in the future if there does not exist a present obligation to a party external to the entity.

Definition of "Recognised"

10 **"Recognised" means reported on, or incorporated in amounts reported on, the face of the financial statements of the entity (whether or not further disclosure of the item is made in notes thereto).**

Recognition

11 Reporting of information about assets, liabilities, equity, revenues and expenses in financial reports may be by way of recognition and/or by disclosure in notes in the financial report. An item may be recognised as an element either singly or in combination with other items. For example, a particular asset may be recognised by incorporation in the carrying amount of a class of assets reported in the statement of financial position. In addition, where assets and liabilities have been set off against each other, or where revenues and expenses have been netted off, in the presentation of those items in financial statements, those elements would nonetheless have been recognised. The manner in which recognised elements should be presented in financial statements, including the circumstances in which they may be set off or netted off, are matters of display which are beyond the scope of this Statement. Inclusion of an element only in notes in the financial report does not constitute recognition.

Disclosure where the Recognition Criteria are not met

12 Elements of financial statements that fail the recognition criteria set out in this Statement would warrant disclosure in notes in the financial report if they are considered to be relevant to users of the financial report in making and evaluating decisions about the allocation of scarce resources.

FINANCIAL POSITION

13 Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting" defines financial position as the economic condition of a reporting entity, having regard to its control over resources, financial structure, capacity for adaptation and solvency. The primary financial measures of an entity's economic condition are reported in the statement of financial position, the elements of which are assets, liabilities and equity.

Assets

Definitions

14 **"Assets" are future economic benefits controlled by the entity as a result of past transactions or other past events; and**

"control of an asset" means the capacity of the entity to benefit from the asset in the pursuit of the entity's objectives and to deny or regulate the access of others to that benefit.

Essential Characteristics of Assets

15 The definition of assets identifies three essential characteristics. First, there must be future economic benefits. Second, the entity must have control over the future economic benefits such that it is able to enjoy the benefits and deny or regulate the access of others to the benefits. Third, the transaction or other event giving rise to the entity's control over the future economic benefits must have occurred.

16 The definition of assets identifies the essential features of assets but does not specify the conditions that would need to be met before an asset qualifies for recognition. Criteria for the recognition of assets are set out in paragraph 38 and discussed in paragraphs 39 to 45.

17 Assets commonly have other characteristics, such as acquisition at a cost to the entity, tangibility, exchangeability, and legal enforceability. However, these are not essential characteristics and the absence of any or all of them is not sufficient to preclude an item from qualifying as an asset. Paragraphs 32 to 37 explain why these are not essential asset characteristics.

Future economic benefits

18 "Future economic benefits" or service potential is the essence of assets. "Future economic benefits" is synonymous with the notion of service potential, and is used in this Statement as a reference also to service potential. Future economic benefits can be described as the scarce capacity to provide benefits to the entities that use them, and is common to all assets irrespective of their physical or other form. In pursuing their objectives, both profit-seeking and not-for-profit entities provide goods and services that have the capacity to satisfy human wants and needs. Both types of entity create utility and value in essentially the same way – by using assets to provide goods and services that their customers or beneficiaries desire or need. Thus, assets provide a means for entities to achieve their objectives.

19 In profit-seeking entities, whether in the private or public sector, the future economic benefits are used to provide goods and services for exchange with the objective of generating net cash inflows; for example, through sale of the asset which embodies the future economic benefits, or sale of the outputs produced through use of the asset. The net cash inflows generated by the future economic benefits may include reductions in cash outflows, such as where an entity's research and development efforts produce a technologically superior production process which lowers the costs of production and thereby reduces the entity's cash outflows. However, many expenditures and other events which have the effect of reducing future cash outflows do not give rise to future economic benefits, and therefore do not give rise to assets. For example, redundancy payments to employees which would avoid cash outflows in the future in respect of those employees would not entitle the employer to future services from the employees and do not give rise to future economic benefits. Accordingly, those payments do not give rise to assets.

20 In not-for-profit entities, whether in the public or private sector, the future economic benefits are also used to provide goods and services in accordance with the entities' objectives. However, since the entities do not pursue profit objectives, the provision of goods and services may not result in net cash inflows to the entities as the recipients of the goods and services may not transfer cash or other benefits to the entities in exchange.

21 The fact that not-for-profit entities do not charge, or do not charge fully, their beneficiaries or customers for the goods and services they provide does not deprive those outputs of utility or value; nor does it preclude the entities from benefiting from the assets used to provide the goods and services. For example, assets such as monuments, museums, cathedrals and historical treasures provide needed or desired services to beneficiaries, typically at little or no direct cost to the beneficiaries. These assets benefit the entities by enabling them to meet their objectives of providing needed services to beneficiaries.

22 Cash on hand and on deposit is of benefit to an entity because of the command over future economic benefits it provides. Cash can be readily exchanged for goods and services. Some assets, such as debtors and investments, are direct claims to cash inflows which are expected to occur when customers pay their accounts, when investees pay interest or dividends, or when an investment is repaid or sold. Payments made to external parties for services to be received from them in the future, that is, prepayments, are assets because they represent existing rights to receive services. Other assets provide benefits to the entity by being exchanged for cash, claims to cash or other goods and services (for example, inventories of finished goods); by being used to provide goods or services (for example, land and buildings, plant and equipment, and patents); or by being used to settle liabilities.

23 The future economic benefits can be distinguished from their source – a particular object or right. The definition refers to the benefits and not to their source since, in the absence of future economic benefits, the object or right will not be of benefit to the entity and therefore will not qualify as an asset. This means that the assumption that a particular type of object or right will always be an asset is not justified. For example, while a machine would normally be associated with future economic benefits, there may be circumstances where it would not qualify as an asset because it has become obsolete or unusable and has no scrap value. Further, the future economic benefits expected from objects or rights may, by virtue of specific business arrangements, be shared by more than one entity. For example, each party to a joint venture may have an interest, as tenant in common, in each of the objects or rights committed to the joint venture and may possess assets comprising their respective shares of the objects or rights. Also, lease agreements unbundle the future economic benefits embodied in leased property by giving the lessee the right to hold and use the property and the lessor the right to receive rentals and any residual value.

Control by a particular entity

24 The second essential characteristic of an asset is control, which relates to the capacity of the entity to benefit from the asset in the pursuit of its objectives and to deny or regulate the access of others to that benefit. The entity controlling an asset is the one that can, depending on the nature of the asset, exchange it, use it to provide goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners. An asset is specific to an entity in that it cannot at the same time be an asset of another entity, except in those circumstances where the asset is controlled indirectly through the entity by virtue of control of the entity by another entity. In these circumstances, the asset would be recognised in the financial report of the entity that directly controls the asset and in the financial report of the economic entity comprising the controlled and parent entities.

25 The capacity of an entity to control the future economic benefits would normally stem from legal rights and may be evidenced by title deeds, possession, or other sanctions and devices that protect the entity's interests. However, legal enforceability of a right is not a prerequisite to the establishment of control over the future economic benefits, since an entity may be able to control the future economic benefits expected to flow from a particular item or activity in some other way. Legal enforceability is discussed further in paragraph 37.

26 Possession or ownership of an object or right would normally be synonymous with control over the future economic benefits embodied in the object or right. However, these are not essential asset characteristics. An entity may possess an object or right but not expect to enjoy the benefits embodied in it. For example, an agent may hold goods for sale on behalf of a principal. Conversely, an entity may not possess an object or right but expect to enjoy its benefits. Also, an entity may control an object or right but not own it. For example, under a lease agreement, control over the leased property owned by the lessor is transferred to the lessee (although the extent and duration of control will vary according to the terms of the agreement). Conversely, an entity may own an object or right but not control it.

27 Some future economic benefits will not be controlled by the entity, because the entity cannot deny or regulate the access of other entities to the objects or rights in which the future economic benefits are embodied. For example, public highways represent future economic benefits to the entities that use them, but cannot qualify as assets of entities other than the entity or entities responsible for their operation. This is because the entities that use the highways are

unable to control access to them by other entities. Similarly, general access to air or water does not qualify as assets of the entities that use them, even if the entities have incurred costs to help clean the environment.

28 The concept of control permits weight to be given to economic and social sanctions where they are effective in inducing entities to fulfil promises or to comply with widely accepted business practices or customs. Thus, inclusion in the definition of assets of a control test rather than a legal enforceability test means that the definition is less rigid and more reliable in assessing the capacity of an entity to secure the future economic benefits.

Occurrence of past transaction or other past event

29 The third essential characteristic of an asset is that the transaction or other event giving the entity control over the future economic benefits must have occurred. Most assets are obtained by an entity from cash, credit or barter transactions. The transactions may be exchange transactions whereby assets are acquired in exchange for existing assets of the entity, or by undertaking an obligation to transfer assets in the future. Alternatively, the transactions may be non-reciprocal transfers, for example, donations, grants, appropriations and contributions by owners or members. Assets may also result from events such as accretion and discovery.

30 Specification of a temporal characteristic has the effect of distinguishing between the future economic benefits of present and future assets of the entity. Future economic benefits that are not controlled at the present time would not qualify as assets. Thus, for the entity to decide prior to the reporting date to acquire a new productive facility does not of itself create an asset for the entity, even though there may be a high probability that the entity will acquire the facility and enjoy the future economic benefits embodied therein.

Other Characteristics of Assets

31 In paragraph 17 of this Statement, asset characteristics additional to those discussed above were identified. Paragraphs 32 to 37 explain why these characteristics are indicative but not essential characteristics of an asset.

Acquisition at a cost

32 Assets are normally acqu ired at a cost incurred by the entity, whether directly in an exchange transaction or indirectly in a production or

distribution activity which transforms or uses up other assets acquired at a cost. However, cost incurrence is not intrinsic to the existence of an asset. While the incurrence of costs by an entity may provide evidence of the existence of future economic benefits, it will not be conclusive proof since costs may be incurred without obtaining future economic benefits. Equally, as is noted in paragraph 29, assets may be obtained without a cost.

Tangibility

33 Tangibility is not an essential asset characteristic. For example, receivables, prepayments, patents, trademarks and goodwill can all embody future economic benefits, even though they do not have physical substance. Furthermore, objects which possess physical form will not necessarily meet the definition of assets. As is explained in paragraph 23, it is the presence of future economic benefits, not the physical or other form of an object or right, that is relevant in assessing whether an asset exists.

Exchangeability

34 Exchangeability means that an item is separable from the entity and has a separate disposal value.

35 Exchangeability is not an essential asset characteristic because future economic benefits are not precluded by the inability to sever an asset from the entity, nor are they necessarily related to the existence of a present disposal value. For example, work in process and specialised plant and equipment may have zero or negligible disposal values, yet as part of a productive process they could be expected to provide substantial future economic benefits to the entity. Similarly, while goodwill is not severable from the entity, it nonetheless meets the definition of an asset since it comprises the future economic benefits embodied in unidentifiable assets. These unidentifiable assets (which are those items which possess the essential characteristics of assets but are not capable of being individually identified) would usually include market penetration, effective advertising, good labour relations, superior management and a highly skilled workforce.

36 Although exchangeability is not an essential asset characteristic, the existence of a separate disposal value will provide evidence of the existence of future economic benefits.

Legal enforceability

37 Control over future economic benefits has been identified as an essential asset characteristic. While the ability of an entity to

exercise control will often stem from the existence of legally enforceable rights, the absence of legal ownership does not preclude the existence of control. For example, an entity may protect the future economic benefits embodied in a formula or an invention not by obtaining a patent but by maintaining secrecy. Similarly, the presence of legal rights does not guarantee control. For example, goods may be sold subject to reservation of title, whereby a stipulation is placed in a sale of goods agreement to the effect that ownership of the goods does not pass to the buyer until the time of payment. The substance of these arrangements is that the buyer effectively has control over the future economic benefits embodied in the delivered goods unless there is an incapacity to pay. The seller, while possessing legal title and therefore the right to resume possession in the event of the buyer's default, does not control the future economic benefits embodied in the goods. Another example is where a government entity, such as a government department, does not have legal ownership of the buildings in which it operates, such ownership vesting in another government entity, but controls the future economic benefits embodied in the buildings because of the terms of a particular government policy, ministerial directive or administrative arrangement.

Criteria for Recognition of Assets

38 **An asset should be recognised in the statement of financial position when and only when:**

(a) it is probable that the future economic benefits embodied in the asset will eventuate; and

(b) the asset possesses a cost or other value that can be measured reliably.

Probable future economic benefits

39 In paragraph 15 of this Statement, one of the essential characteristics of an asset was identified as future economic benefits. However, for an asset to qualify for recognition it must be probable that the future economic benefits will eventuate.

40 The term "probable" means that the chance of the future economic benefits arising is more likely rather than less likely. The term is used in this Statement with its usual meaning and refers to that which can be expected on the basis of available evidence or logic.

41 Assessments of the degree of certainty attaching to the future economic benefits in any particular situation are made on the basis of available evidence. An amount receivable, due for settlement shortly after the reporting date and owed by a reputable entity, may not be received if, for example, the debtor suddenly suffers from severe financial problems after the reporting date. Nonetheless, at the reporting date, the likelihood of non-receipt is remote and thus the debt would satisfy the criteria for recognition as an asset.

42 Where an expenditure has been made but it is not considered probable, at that time, that future economic benefits will flow to the entity, an asset would not qualify for recognition. This does not imply that management's intention in making the expenditure was other than to generate future economic benefits or that, in making the expenditure with this intention, management was misguided; nor, indeed, does it imply that the item fails to satisfy the definition of an asset. The only implication is that, on the basis of the available evidence, the necessary degree of certainty for the item to satisfy the criteria for recognition as an asset does not exist. Future economic benefits arising from some research and development expenditure, for example, may not qualify for recognition as an asset because it is not possible, at the date of the expenditure, to establish that it is probable that future economic benefits will eventuate.

43 An asset which, at a particular point in time, fails the test of probable future economic benefits may nonetheless qualify for recognition as an asset at a later date as a result of subsequent transactions or other subsequent events. The asset would qualify for recognition even though this may involve amounts that had previously been recognised as expenses by the entity. For example, an entity may have recognised as expenses exploration costs in relation to a particular area of interest, and subsequently confirmed the existence of a valuable mineral deposit.

Reliable measurement

44 For an asset to satisfy the recognition criteria it is necessary that it possesses a cost or other value that can be measured reliably. The term "reliably" is used in this Statement with the corresponding meaning to that ascribed to the term "reliability" in Statement of Accounting Concepts SAC 3 "Qualitative Characteristics of Financial Information".

45 The appropriate measurement basis for an asset will depend upon the model of accounting being applied. In most cases, assets will have a cost or other value that can be measured reliably in accordance with the particular accounting model. However, in some cases an item

may not possess a cost or other value that can be measured reliably. In those cases, the item would not qualify for recognition as an asset under any of the models. For example, a mining company may have discovered, at immaterial cost, evidence of minerals at one of its exploration sites, but not be in a position as at the reporting date to know the extent of the find or its value.

Disclosure where the recognition criteria are not met

46 Assets that are not recognised because it is not considered probable that future economic benefits will flow to the entity may warrant disclosure in the notes in the financial report because knowledge of the assets is considered to be relevant to the users of the financial report in making and evaluating decisions about the allocation of scarce resources. For example, expenditure on computer software development may meet the definition of an asset and the recognition criterion of reliable measurement, but may fail to qualify for recognition as an asset because, in the particular circumstances of the entity, it does not satisfy the recognition criterion relating to probability of occurrence of future economic benefits. However, information about the asset may be considered to be relevant to the users of the financial report in making and evaluating decisions about the allocation of scarce resources, and accordingly may warrant disclosure in the notes in the financial report.

47 Assets that are not recognised only because they do not possess a cost or other value that can be measured reliably may also warrant disclosure in the notes in the financial report because knowledge of the assets is considered to be relevant to the users of the financial report in making and evaluating decisions about the allocation of scarce resources. For example, an entity may, at the reporting date, be engaged in litigation in pursuit of a claim for damages. While it may be probable that future economic benefits will eventuate, it may be impossible to reliably measure the value of the claim. Nonetheless, disclosure of the claim, if material, could assist users in making assessments related to the present and expected future financial position of the entity.

Liabilities

Definition

48 **"Liabilities" are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events.**

Essential Characteristics of Liabilities

49 The existence of a liability at law is usually a clear indication of the existence of a liability for financial reporting purposes; however, the attributes of a legal liability may be unnecessarily restrictive in defining a liability. Paragraphs 51 to 64 identify the characteristics which are considered essential to the existence of a liability.

50 The definition of liabilities identifies the essential features of liabilities but does not specify the conditions that would need to be met before a liability qualifies for recognition. Criteria for the recognition of liabilities are set out in paragraph 65 and discussed in paragraphs 66 to 69.

Existence of a present obligation

51 An essential characteristic of a liability is the exist ence of a present obligation, being a duty or responsibility of the entity to act or perform in a certain way. An obligation implies the involvement of two separate parties, namely the entity and a party external to the entity, since the same party cannot be both the recipient of the performance and the party under the duty to perform.

52 It is not necessary that the identity of the party to whom an obligation is owed be known in order for a present obligation to exist. For example, an employer may have a present obligation for long service leave without knowing the identity of each of the employees who ultimately will qualify for payment. Similarly, a general insurer will have a present obligation for claims incurred but not reported prior to the reporting date. A present obligation means that a transaction or other event in the past has given rise to an obligation which has not yet been satisfied.

53 The party to whom a present obligation is owed may differ from the party or parties which will receive goods or services as satisfaction of the obligation. For example, a multiple subscriber to a publication may nominate various parties to whom copies of the publication are to be provided. Nevertheless, the present obligation of the publisher for subscriptions received in advance is to the multiple subscriber.

54 Most obligations are legally enforceable in that they stem from legally binding contracts or are imposed by legally authorised bodies or government statutes. Examples of obligations arising from contractual arrangements include amounts borrowed; amounts owed for assets purchased; amounts owed for obtaining the services of labour; and obligations to provide goods or services to parties who have, as part of a reciprocal transaction, paid in advance for those

items. Obligations imposed on an entity would include damages awarded in a law suit, claims owed under workers' compensation schemes, obligations under legislation or licence conditions to rehabilitate mine sites, and income tax payable.

55 Obligations can also be equitable or constructive. An equitable obligation is governed by social or moral sanctions or custom rather than legal sanctions; that is, it stems from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just and right – to do what one ought to do in the pursuit of one's objectives rather than only what one is legally required to do. An example of an equitable obligation is where a profit-seeking entity, based on moral considerations, undertakes to rectify faults in one of its products even where these become apparent after the warranty period has expired. As a result, the amounts expected to be sacrificed in accordance with this policy in relation to goods already sold would constitute an obligation.

56 A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. An example of a constructive obligation is where an entity has a policy of paying periodic bonuses to employees even though it is not contractually bound to do so, and bonuses for the current reporting period have not yet been paid.

57 There is no doubt that legally enforceable obligations of an entity are liabilities. However, the concept of liabilities adopted in this Statement encompasses the financial obligations imposed by notions of equity or fairness, and by custom or usual business practices, as well as those resulting from legally enforceable contracts, from imposition by legally authorised bodies, from statutes or from torts. While, in practice, difficulties may be encountered in determining whether equitable or constructive obligations exist, it is considered that knowledge of such obligations is relevant to users of financial reports in making and evaluating decisions about the allocation of scarce resources.

58 The existence of a present obligation is easily established in most cases. Most obligations are evidenced by formal documentation, such as contracts, and are legally enforceable by the other party. In the absence of a clear legal responsibility, the existence of a present obligation is a matter for determination from the evidence available.

59 It is important to distinguish between present obligations and future commitments to ensure that too wide a definition of liabilities is not adopted. The mere intention to sacrifice economic benefits in the

future is not sufficient to give rise to a liability. For example, the management of an entity may decide to acquire assets in the future. Such a decision does not, of itself, create a present obligation. A liability would normally only arise when the entity had acquired the assets and was obliged to pay for them. Further, the formal adoption of a budget, the passing of appropriation legislation or the establishment of a grant programme by a government do not, of themselves, create present obligations for the government. Only on the subsequent placing of orders or approval of grant applications does a present obligation arise.

60 Furthermore, the action of an entity in setting aside reserves for a future event does not give rise to a liability. For example, some entities that carry out overhauls, repairs and renewals relating to major items of property, plant and equipment regularly "provide" in their financial reports for such work to be undertaken in the future, with concomitant recognition of an expense. These provisions do not satisfy the definition of liabilities, because the entity does not have a present obligation to an external party. An obligation would normally only arise when the future repair work is performed. However, application of the concepts in this Statement would involve the recognition of depreciation expenses as the future economic benefits embodied in existing components of property, plant and equipment are consumed in the operations of the entity. Also, some entities create "provisions" for uninsured future losses (sometimes known as "self-insurance provisions") for the purpose of retaining funds in the entity to meet losses which may arise in the future. In these situations, the entity does not have an obligation to an external party. An obligation would only arise when a future event occurred which would necessitate the sacrifice of economic benefits by the entity.

Obligation involves settlement in the future: sacrifice of economic benefits

61 Another essential characteristic of a liability is that it has adverse financial consequences for the entity in that the entity is obliged to sacrifice economic benefits to one or more entities. Thus, the existence of a liability depends on the present obligation being such that the legal, social, political or economic consequences of failing to honour the obligation leave the entity little, if any, discretion to avoid the future sacrifice of economic benefits to another entity. Where an entity places an order for the purchase of goods, for example, this action would not, of itself, normally give rise to a liability, since the entity would normally have the discretion to avoid the future sacrifice of economic benefits by being able to cancel the order without the other party being able to enforce performance by the entity. The

receipt of the goods would normally be the event that would create the liability. However, if the goods were to be made to the specifications of the purchaser, it may not be possible to cancel the order after, say, the supplier commenced manufacture of the goods because legal remedies are available to the other party, in the form of court orders for specific performance or in the form of a penalty set sufficiently large as, in normal circumstances, to deter cancellation of the order. In these circumstances a liability would exist when the supplier commenced manufacture of the goods.

62 The future sacrifices of economic benefits that an entity is obliged to make to other entities may be in various forms. For example, those sacrifices may be in the form of transfers of goods, cash or cash equivalents to other entities and/or the using up of plant, equipment and consumable stores in the provision of goods or services to other entities. The bases and techniques which may be appropriate for measurement of each of these forms of sacrifice are beyond the scope of this Statement. These issues will be the subject of a separate Statement of Accounting Concepts.

63 Settlement of the obligation may be required on demand, on a specified date or on the happening of a specified event. As is noted in paragraph 61, for a liability to exist the obligation must be such that the entity has little or no discretion to avoid the future sacrifice of economic benefits in satisfaction of the obligation. If the entity obliged to make the settlement had an unfettered right to decide the settlement date, it would have complete discretion as to whether economic benefits were to be sacrificed for that purpose and therefore a liability would not exist in respect of the obligation.

64 While a high degree of certainty of settlement may be associated with some liabilities, others may involve significant uncertainty. Where settlement of an obligation is required on demand, there exists a possibility that the demand may never be made by the party entitled to the economic benefits. Alternatively, the event which signals the necessity for the sacrifice of economic benefits may never occur. For instance, the granting of a guarantee for a loan creates an obligation to sacrifice economic benefits to another entity were settlement of the obligation to be required. However, until the borrower defaults it is not known whether the guarantor will be required to honour the guarantee. In these circumstances, the liability created by entering into the guarantee will only qualify for recognition if and when it becomes probable that the borrower will default and settlement will be required.

Criteria for Recognition of Liabilities

65 **A liability should be recognised in the statement of financial position when and only when:**

(a) it is probable that the future sacrifice of economic benefits will be required; and

(b) the amount of the liability can be measured reliably.

Probability of future sacrifice of economic benefits being required

66 In paragraph 61 of this Statement, one of the essential characteristics of a liability was identified as being that a future sacrifice of economic benefits will be required. The probability of a sacrifice of economic benefits being required in the future to satisfy an obligation ranges from virtual certainty to virtually no chance. Obligations may range from being mature, whereby they are due immediately and performance is not subject to the happening of any event; to unconditional, in which only the passage of time is required to make their performance due; to conditional obligations, which require the occurrence of an event that is not certain to occur before they become either unconditional or mature. Hence, whether a liability qualifies for recognition depends on the probability of the sacrifice of economic benefits being required in the future. Mature and unconditional obligations clearly satisfy any criterion regarding the probability of the future sacrifice of economic benefits being required and, subject to meeting the test of reliable measurement, satisfy the criteria for recognition as liabilities. However, conditional obligations which meet the test of reliable measurement would satisfy the recognition criteria only if it is probable that the event that will necessitate the future sacrifice of economic benefits will occur.

67 This Statement states that a liability should be recognised if it is probable that a future sacrifice of economic benefits will be required in satisfaction of a present obligation, provided the other recognition criterion is also satisfied. The term "probable" means that the chance of the future sacrifice of economic benefits being required is more likely rather than less likely.

Reliable measurement

68 For a liability to satisfy the recognition criteria it is necessary that the amount of the liability can be measured reliably.

69 The amount recorded as a liability represents the monetary expression of the obligation to sacrifice economic benefits. The

measurement of different liabilities can vary in reliability. Verifiable evidence of the nominal amounts to be paid and of the dates of payment is available for the majority of liabilities, such as those resulting from the purchase of goods or services, or from the borrowing of money to finance the entity. At the other extreme, a liability may have a range of possible nominal values.

Disclosure where the recognition criteria are not met

70 Liabilities that are not recognised because it is not probable that a future sacrifice of economic benefits will be required may warrant disclosure in the notes in the financial report because knowledge of the liabilities is considered to be relevant to the users of the financial report in making and evaluating decisions about the allocation of scarce resources. For example, an entity may, at the reporting date, be engaged in litigation in defence of a claim for a specified amount of damages. The claim may meet the recognition criterion of reliable measurement, but may fail to qualify for recognition as a liability because, in the particular circumstances of the entity, it does not satisfy the recognition criterion of probable future sacrifice of economic benefits. However, information about the liability may be considered to be relevant to the users of the financial report in making and evaluating decisions about the allocation of scarce resources, and accordingly may warrant disclosure in the notes in the financial report.

71 Liabilities that are not recognised because they cannot be measured reliably may also warrant disclosure in the notes in the financial report because knowledge of the liabilities is considered to be relevant to the users of financial reports in making and evaluating decisions about the allocation of scarce resources. For example, an entity may have a liability for warranty repairs for a new product line, or a liability for the repair of environmental damage the cost of which is to be assessed by a court. While in either instance it may be probable that a future sacrifice of economic benefits will be required, in the particular circumstances of the entity it may be impossible for the liability to be measured reliably. Nonetheless, disclosure of the liability, if material, could assist users in making assessments of the present and expected future financial position of the entity.

Discontinued Recognition of Assets and Liabilities

72 In applying the definitions and recognition criteria for assets and liabilities, a previously recognised asset or liability would cease to be recognised when, and only when, it ceases to satisfy the definition of

the element or ceases to satisfy either or both of the criteria for its recognition.

Definitions

73 The definition of assets would cease to be satisfied where an asset is sold or settled (for example, settlement through collection in full of an account receivable), where the entity loses control over the future economic benefits comprising an asset (for example, where the entity is unable to renew a property lease and loses its right to the leased property, including leasehold improvements) or where an asset ceases to comprise future economic benefits (for example, where an option held by the entity expires, or where equipment suffers total impairment). The definition of liabilities would cease to be satisfied where the obligation is settled (through payment, forgiveness or conversion into equity) or where a creditor's claim against the entity lapses (for example, where an option written by the entity expires).

Recognition criteria

Probable future benefit or probable future sacrifice

74 An asset would cease to qualify for recognition where it ceases to be probable that the future economic benefits embodied in the asset will eventuate. A liability would cease to qualify for recognition where it ceases to be probable that the entity will be required to make a future sacrifice of economic benefits. These assessments may occur as a result of a change in the entity's circumstances. (For example, a change in market conditions may indicate that further development of a product would not be viable and therefore that it is improbable that any recovery of product development costs recognised as an asset will occur. Another example is where a change in market conditions indicates that it is no longer probable that an underwriter will be called to meet a claim under an excess of loss insurance contract.) These assessments may also occur as a result of obtaining further information about the likelihood of benefits eventuating or a sacrifice being required (for example, receiving further advice about the likelihood of a disputed claim for damages by, or against, the entity being proven).

Reliable measurement

75 In some circumstances, an entity may cease to be able to measure reliably an asset or a liability, in which case the asset or liability would cease to qualify for recognition.

Agreements Equally Proportionately Unperformed

76 Agreements equally proportionately unperformed are agreements in which neither party has fulfilled any promises, and agreements in which both parties have performed to an equal extent some of their promises while other promises have yet to be honoured. Examples of such agreements include purchase orders for materials or equipment, leases, forward exchange contracts, commodity futures contracts and certain types of employment agreements.

77 Some agreements equally proportionately unperformed would give rise to assets and liabilities. That is, some entities would obtain control over future economic benefits, and incur a present obligation to sacrifice economic benefits in the future, as a result of entering into agreements which are equally proportionately unperformed. In some of those instances, it could be argued that those items would satisfy the definitions of assets and liabilities and the criteria for their recognition in the statement of financial position. In respect of some agreements which are equally proportionately unperformed, such as certain forms of lease, it is generally accepted that the definitions of assets and liabilities and the criteria for their recognition would normally be satisfied. However, for many other agreements, significant uncertainty may exist as to whether the definitions and recognition criteria would be satisfied. In addition, substantial difficulties may arise in determining a reliable and appropriate measure for assets and liabilities which may arise from these agreements. These difficulties are reflected in the fact that recognition of all assets and liabilities which arise from these agreements and satisfy the criteria for recognition would represent a fundamental change to existing reporting practices in Australia and in overseas jurisdictions.

Equity

Definition

78 **"Equity" is the residual interest in the assets of the entity after deduction of its liabilities.**

Nature of Equity

79 A statement of financial position for an entity comprises amounts assigned to the assets of the entity, amounts assigned to its liabilities, and a net amount, being the difference between the amounts assigned

to its assets and liabilities. This net amount represents an element of the statement of financial position.

80 This element has been given various descri ptions in financial reports. For example, in the private sector it has been called equity, owners' equity, shareholders' equity, equity capital, capital, capital and reserves, partners' capital, shareholders' funds, proprietorship, and ownership; in the public sector it has been called equity, public equity, contributed equity, and government equity.

81 In this Statement, the term "equity" has been chosen to describe this element. This expression is neutral, in that, unlike most of the other terms referred to above, it implies nothing about the entity's operating structure or objectives.

82 The liabilities and equity of an entity are mutually exclusive interests in the entity's assets by parties external to the entity. The concept of equity is defined in this Statement as the residual interest in the assets of an entity, that is, the interest in the assets of the entity that remains after deduction of its liabilities. The residual interest can be interpreted as a claim or right to the net assets of the entity.

83 Defining equity as a residual is based on the view that equity cannot be defined independently of the other elements comprising the statement of financial position. Accordingly, the concepts of assets and liabilities must be defined before a definition of equity can be made operational.

84 For every entity, the residual rights to the assets of the entity are held by some party or parties who will be the recipient(s) of any assets remaining after the liabilities of the entity have been satisfied. In relation to a profit-seeking entity that operates in the private sector, equity is the financial interest of the ownership group in the entity. It stems from ownership rights and involves a relationship between the entity and its owners as owners rather than as, for example, employees, suppliers, customers or lenders. In a not-for-profit entity in the private sector, there is typically an absence of defined financial interests of an ownership group which can be sold, transferred or redeemed, or that convey entitlement to a share of the residual assets in the event of the entity being wound up. However, some party or parties would be entitled to any assets remaining after the liabilities have been satisfied. In the case of both profit-seeking and not-for-profit entities in the public sector, it is normally the community, through its elected representatives in government, which holds the ultimate ownership rights.

Characteristics of Equity

85 Equity ranks after liabilities as a claim to the assets of an entity. In the event of the entity being wound up, all liabilities must be met before a distribution can be made to those parties with a right to participate in any assets remaining after the liabilities have been satisfied. This characteristic implies that equity is a residual interest; it is the claim to the net assets of the entity, that is, to the assets after liabilities have been deducted.

86 Equity bears the results of operations and the consequences of other events affecting the entity. Equity is enhanced by profitable operations and by contributions by owners. Equity is diminished by unprofitable operations and by distributions to owners.

87 The assets and liabilities of an entity can be specified independently of the other elements – each asset represents future economic benefits controlled by the entity, and each liability is a present obligation of the entity. However, equity cannot be so specified: it is a net position or residual interest.

Components of Equity

88 Equity is increased by contributions by owners and excesses of revenues over expenses resulting from the operations of the entity. Equity is decreased by excesses of expenses over revenues and by distributions to owners. Contributions by owners and distributions to owners are discussed in paragraphs 145 and 146.

89 Equity will be influenced by the concepts of capital and capital maintenance adopted in the preparation of financial reports. The concepts of capital and capital maintenance adopted will influence the amount and components of equity where those concepts give rise to what can be termed measurement adjustments. These adjustments are discussed in paragraphs 147 and 148.

Equity in Not-for-Profit Entities

90 Contributions made to not-for-profit entities by, for example, donors, members, governments and others are non-reciprocal transfers in the sense that the recipient is not required to give approximately equal value in exchange directly to the contributor (commentary on the characteristics of reciprocal and non-reciprocal transfers is set out in paragraphs 100 to 105). Contributions made to not-for-profit entities are revenues unless they are of the nature of contributions by owners.

Typically, contributions to not-for-profit entities are not contributions by owners because the contributors do not expect to receive a financial return commensurate with the assets provided, nor do the contributors obtain by way of the contributions a financial interest in the net assets of the entity that can be sold, transferred or redeemed. However, the contributors will normally have a continuing interest in how the entity deploys contributed assets and will often impose temporary or permanent restrictions on their use.

91 Restrictions impose fiduciary responsibilities on managements and governing bodies to ensure that contributed assets are used by the entity in the manner stipulated by the contributors. The restrictions may relate to specific assets; for example, the entity may be given an historical treasure with the stipulation that it be properly maintained and never sold. However, the entity is normally able to pool contributed assets with other assets and to sell or exchange the contributed assets for other suitable assets provided that the future economic benefits represented by the contributed assets are not deployed in a way contrary to the contributors' stipulations. For example, assets may be provided for the purpose of acquiring a building, or for investing in securities the revenues from which are to be used to award scholarships for overseas study. In the former case, once the building has been acquired the restriction on the assets ceases and the building would be regarded as an unrestricted asset. In the latter case, the restriction on the assets would be permanent. As discussed in paragraphs 98 to 107, restrictions on contributed assets, whatever the form of the restriction, do not constitute present obligations of the entity and therefore do not, of themselves, cause the associated contributions to satisfy the definition of liabilities.

Recognition of Equity

92 Since equity is the residual interest in the assets of an entity and the amount assigned to equity will always correspond to the excess of the amounts assigned to its assets over the amounts assigned to its liabilities, the criteria for the recognition of assets and liabilities provide the criteria for the recognition of equity.

93 If the aggregate amount assigned to an entity's liabilities exceeds the aggregate amount assigned to its assets there would be no amount recognised as equity. What would be reported is a deficiency of reported assets compared with reported liabilities. As with the reported amount of equity, the reported amount of any deficiency would depend on the bases on which the entity's assets and liabilities are recognised and measured. It is possible for the reported liabilities of an entity to exceed its reported assets and for the ownership group

or, where there is an absence of an ownership group, some other party or parties with residual rights, to have an interest of some value in the entity. For example, assets may exist but not have been recognised, or a measurement basis may have been adopted which does not report the current value of the reported assets and liabilities. Notwithstanding this, the existence of legal restrictions, for example, may inhibit the ability of an entity that reports a deficiency to make distributions to owners.

Equity and Liabilities

94 The distinction between equity and liabilities may be obscure in practice. Since equity has been defined in this Statement as a residual interest, the classification of securities as equity or liabilities would involve an assessment of whether the securities meet the definition of liabilities and the criteria for recognition as liabilities.

Profit-seeking entities

95 For profit-seeking entities, the distinction between liabilities and equity is based upon the legal status of, and the priority attaching to, the two types of claims. Liabilities are generally claims for a stated or determinable sum. Equity is not, because owners enjoy the rewards and bear the losses of the entity's operations. Moreover, settlement of liabilities may be required on demand, at a specified or determinable date, or on the happening of a specified event. In contrast, an entity is not obliged to transfer assets to its owners except where it formally acts to undertake a distribution, as in the case of the declaration of a dividend, or where the entity is being wound up, in which case any assets remaining after the satisfaction of liabilities are distributed to owners.

96 Difficulties in distinguishing liabilities from equity can arise in many practical situations for profit-seeking entities. Profit-seeking entities may issue securities which appear to have the characteristics of both equity and liabilities. In addition, the names given to some securities may not be an accurate description of their essential characteristics. Examples of these types of securities are preference shares, convertible debt and "perpetual" capital notes.

97 The classification of securities as liabilities or equity or as comprising equity and liability components should determine the appropriate treatment of amounts paid or payable to the security holders as a return on their investments in the entity. If a security, or a component of a compound security, previously classified as a liability is reclassified as equity during the reporting period, the return on the

security or the component of the security that accrues from the time of the reclassification should be accounted for as a distribution to owners rather than as interest expense.

Not-for-profit entities

98 For not-for-profit entities, the distinction between liabilities and equity may be obscured by the imposition by donors, members, governments and others of restrictions, whether explicit or implicit, on the use to which contributed assets may be put. An entity's responsibility to comply with the restrictions does not constitute a present obligation as discussed in paragraphs 51 to 60 and therefore does not, of itself, provide grounds for identifying the associated contributions as liabilities. The determinant of whether an inflow gives rise to a liability or an increase in equity is whether the transfer is reciprocal or non-reciprocal. This is discussed in paragraphs 100 to 105.

Reciprocal and non-reciprocal transfers

Definitions

99 **"Non-reciprocal transfer" means a transfer in which the entity receives assets or services or has liabilities extinguished without directly giving approximately equal value in exchange to the other party or parties to the transfer; and**

"Reciprocal transfer" means a transfer in which the entity receives assets or services or has liabilities extinguished and directly gives approximately equal value in exchange to the other party or parties to the transfer.

Characteristics of reciprocal and non-reciprocal transfers

100 Not-for-profit entities obtain assets or services to provide particular types of goods and services to consumers and beneficiaries, in accordance with their objectives. Contributions, whether restricted or unrestricted, to a not-for-profit entity are non-reciprocal transfers which are made to maintain or increase the entity's capacity to provide those goods and services.

101 For transfers to an entity to create a present obligation on the entity to make future sacrifices of economic benefits to particular external parties, the transfers would need to be reciprocal, whereby the transferor and transferee directly receive and sacrifice approximately equal value. The value that is received and sacrificed would be in the form of assets, services, extinguishment of liabilities, or a

combination thereof. Examples of reciprocal transfers are sales of goods and services, the provision of loan funds, and the provision of employee services. An exchange of approximately equal value can occur despite differences between the carrying amounts of the assets exchanged, because the parties have obtained mutual benefit. For example, a commercial sale of goods involves an exchange of approximately equal value, irrespective of whether the sale price exceeds the cost of the goods to the vendor.

102 Value is not received in exchange where an entity transfers assets to another entity and only derives benefit from satisfying its objectives of providing benefits to others. Accordingly, for a transfer to be reciprocal, it is not sufficient that the transferor receives benefit indirectly as a result of the transfer. For example, when a government provides a grant to a not-for-profit entity, typically it does not receive value directly in exchange. In such circumstances, it normally would indirectly receive a benefit as a result of the recipient entity deploying the grant in providing goods or services to beneficiaries which the grantor government represents. Similarly, governments are not obliged to provide benefits, in the form of goods or services, to particular taxpayers or ratepayers in return for their taxes and rates.

103 Because an essential feature of reciprocal transfers is the exchange of approximately equal value by the transferor and the transferee, involuntary transfers to not-for-profit entities (such as taxes) would generally be classified as non-reciprocal transfers. That is, although involuntary transfers will normally result in the provision of some goods or services to the transferors, because the transfers are involuntary, receipt and sacrifice of approximately equal value would occur only by coincidence. For example, governments are not obliged to provide commensurate benefits, in the form of goods or services, to particular taxpayers or ratepayers in return for levies imposed on them.

104 If assets are provided to a not-for-profit entity on the condition that the entity is to make a reciprocal transfer of economic benefits, and that reciprocal transfer has not occurred prior to the reporting date, the recipient entity will have a liability. An example is where a payment is made to a local government in advance for repairs to a private road, where the charge would be repayable directly to the provider or providers if the works were not performed.

105 A transfer of economic benefits may comprise two distinct transactions, which are reciprocal and non-reciprocal in nature. For example, if a donor transfers a building to an entity at a price which intentionally is significantly lower than its fair value, the transfer is

in part reciprocal (to the extent that approximately equal value is received in exchange) and in part non-reciprocal. In these circumstances, because a reciprocal transaction is involved, any unsatisfied obligation to provide consideration in return for the building will represent a liability of the recipient of the building.

Fiduciary responsibility

106 The receipt of contributions imposes a fiduciary responsibility on the management or governing body of a not-for-profit entity to use the contributed assets efficiently and effectively in pursuing the objectives of the entity. However, this fiduciary responsibility pertains to all of the entity's assets, not only those in respect of which there are contributor-imposed restrictions, and does not constitute a legal, equitable or constructive obligation in the sense in which those concepts are discussed in paragraphs 54 to 57. A not-for-profit entity's fiduciary responsibility to use assets to provide goods and services to consumers and beneficiaries does not, of itself, create a duty or responsibility on the entity to sacrifice economic benefits to particular external parties.

107 The concepts of equitable and constructive obligations have a relatively narrow area of application. To assess all or most contributor-restricted contributions to not-for-profit entities as having the essential characteristics of liabilities is too broad an interpretation of the definition of liabilities. An analogy is sometimes drawn between the obligation of an entity to sacrifice economic benefits to another entity in return for a prepayment received as part of a reciprocal transaction, and the fiduciary obligation of a not-for-profit entity to deploy restricted contributions in the provision of goods or services to beneficiaries in the future. However, because not-for-profit entities have a fiduciary responsibility to use all of their assets for the provision of goods and services to beneficiaries, if restricted contributions were to be identified as giving rise to liabilities, it would be consistent for liabilities to be recognised in respect of all of the assets of a not-for-profit entity, in which case equity would not be recognised.

108 Notwithstanding the discussion in paragraphs 98 to 107, a liability would arise in respect of contributions received by a not-for-profit entity from donors, members, governments or others where the entity has failed to meet the specific conditions attaching to a contribution and the amount must be repaid. In these circumstances the entity has a present obligation to a creditor that has arisen as a result of a past event, namely the failure of the entity to meet the conditions for retention of the contribution.

PERFORMANCE

<u>*Revenues and Expenses*</u>

109 Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting" states that aspects of the performance of an entity can be measured in financial and non-financial terms. Information about changes in the entity's equity which have occurred during the reporting period, and the extent to which those changes resulted from the entity's operations for that period, is useful to users. The latter information is relevant to an assessment of the entity's financial performance during the reporting period. SAC 2 defines performance as the proficiency of a reporting entity in acquiring resources economically and using those resources efficiently and effectively in achieving specified objectives. The primary financial measures of an entity's performance are reported in the operating statement, the elements of which are revenues and expenses.

110 In assessing the performance of profit-seeking entities, revenues may be related to expenses incurred during the reporting period, and the net result may be evaluated by reference to the assets employed by the entity to achieve the result. In respect of not-for-profit entities, reporting of expenses enables users to assess the cost of goods and services provided by the entity during the reporting period, and reporting of revenues enables users to assess the extent to which the cost of providing goods and services has been recovered by the entity during the reporting period.

<u>*Definition of Revenues*</u>

111 **"Revenues" are inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the reporting period.**[1]

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1 The definition has been structured so as to be applicable to a range of measurement models. Accordingly, in interpreting the definition in a given set of circumstances, it is important to have in mind the particular measurement model which would apply. Paragraphs 129 and 148 contain discussion of the impact of different measurement models on the definition and recognition of revenues.

Characteristics of Revenues

112 The definition of revenues set out in this Statement is linked to the definitions of assets and liabilities, focusing upon gross inflows or other enhancements of future economic benefits and savings in outflows of future economic benefits which would otherwise be required to satisfy liabilities.

113 The inflows or other enhancements of future economic benefits or savings in outflows of future economic benefits that constitute revenues may be of various kinds. For example, revenues in the form of inflows or other enhancements of future economic benefits can arise from the entity providing goods and services, investing in or lending to another entity, holding and disposing of assets, or by receiving contributions such as grants, donations and bequests. Revenues in the form of savings in outflows of future economic benefits can arise where inflows of assets are foregone in return for extinguishment of liabilities, where liabilities are forgiven and where exchange gains arise on translation of loans denominated in a foreign currency. The transactions and other events from which revenues arise, and the revenues themselves, are in many forms and are referred to by a variety of names; for example, output, deliveries, sales, fees, commissions, interest, dividends, royalties, rent and non-reciprocal transfers such as taxes, grants and rates.

114 For a transaction or other event to give rise to revenue as a result of an increase in assets it is necessary that the entity controls the future economic benefits arising from the transaction or other event. For example, where the entity has provided goods and services as part of reciprocal transactions during the reporting period, it has control over the future economic benefits arising from the transactions or other events because it either has an explicit claim against an external party or has received an inflow of cash. Revenues arise once control over the future economic benefits has been achieved, provided that there has not been an equivalent increase in liabilities. Revenues will not normally arise before the provision of goods or services by an entity as part of a reciprocal transaction, because the entity typically will not have established a claim against an external party. For example, where an entity provides services in the form of rental property, revenues will not arise until the entity has a claim against the tenant for rent in respect of the property. This claim will arise progressively as the tenant uses the rental property. If the tenant prepays rent, the increase in future economic benefits does not constitute an item of revenue. This is because even though the entity has control over the cash received, there has been an equivalent liability established in the form of an obligation to provide rental

services over the period of the rental prepayment, with the result that there has been no increase in equity.

Savings in outflows of future economic benefits

115 The definition of revenues includes savings in the outflows o f future economic benefits which would otherwise be required to satisfy liabilities. Where the savings in outflows depend upon the provision of goods or services by the entity, revenues arise in the same pattern as if there were an inflow of cash or the establishment of an explicit claim against an external party, that is, in a pattern which reflects the entity's economic activity in providing the goods or services.

116 In the case of the forgiveness of liabilities, the revenues arise simultaneously with that forgiveness. In a situation in which the provider of debt finance is part of the ownership group – for example, a government in relation to one of its statutory authorities – a question may arise as to whether the forgiveness of debts gives rise to revenues. Some may argue that the debts should simply be reclassified as equity, with no recognition of revenues, on the basis that the forgiveness of debt is consideration for the debt provider obtaining a financial interest in the net assets of the entity. This should be a question of fact for most entities. If the forgiveness of debt represents a contribution by owners – for example, as a result of the acquisition of ordinary shares by the debt provider – it should be identified as a contribution of equity. In all other circumstances, the forgiveness of debt should be identified as an item of revenue.

Definition of Expenses

117 **"Expenses" are consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the reporting period.**

Characteristics of Expenses

118 Expenses represent consumptions or losses of future economic benefits that result from transactions undertaken by, and other events affecting, the entity during the reporting period. Consumptions or losses of future economic benefits occur in the form of reductions in assets or increases in liabilities.

119 The consumptions or losses of future economic benefits that constitute expenses may be of various kinds; for example, future economic benefits will be consumed or will expire during the current reporting period as consumable stores are used, and there will be an outflow of future economic benefits in a future reporting period as a result of the incurrence, during the current reporting period, of a liability for property taxes. The transactions and other events from which expenses arise, and the expenses themselves, are in many forms and are referred to by a variety of names; for example, wages and salaries, depreciation and amortisation, cost of goods sold, cost of services provided, rent and interest.

120 Most expenses result from the use of assets during the reporting period. In many cases, the acquisition and use of assets occurs simultaneously or during the same reporting period; for example, the consumption of future economic benefits resulting from the use of employees' services, power supplies, telecommunication services and property insurance. Where the entity incurs an obligation to pay for these items in the future, rather than paying for them on receipt, it is common practice to recognise only the incurrence of liabilities and expenses, rather than to first recognise the acquisition of assets and the incurrence of liabilities and then to recognise the reduction in assets and the incurrence of expenses. In some cases, however, expenses result directly from the incurrence of liabilities; for example, income tax. These transactions are non-reciprocal transfers and an expense is identified on the basis of an expected outflow of future economic benefits in order to satisfy the obligation incurred.

121 In some cases, the reduction in future economic benefits which gave rise to an expense during the reporting period may have been initiated by the entity with the objective of causing a concurrent increase in future economic benefits in the form of an asset, but may have failed to do so. For example, where an entity makes expenditures as part of a research and development programme with the objective of generating future economic benefits in the form of a new product or process, and the expenditures fail to give rise to an asset that qualifies for recognition, the expenditures would meet the definition of expenses.

Revenues and Expenses: Essential Characteristic of Changes in Equity

122 For a transaction or other event to give rise to a revenue or an expense, it must *inter alia* have the effect of increasing or reducing equity. Where such an effect occurs, the resultant revenue or expense would be identified respectively as the inflow or other enhancement

or saving in outflows of future economic benefits, and the consumption or loss of future economic benefits. An increase in assets resulting from raising debt would neither increase nor reduce equity since there will have been an equivalent increase in liabilities, and the transaction would not, therefore, give rise to a revenue or an expense. Similarly, the purchase of depreciable assets would neither increase nor reduce equity and would not, therefore, give rise to a revenue or an expense. The purchase of depreciable assets will give rise to expenses in future reporting periods as the future economic benefits embodied in the assets are consumed or expire.

123 Non-reciprocal transfers of future economic benefits, such as donations, represent expenses and revenues of the transferor and transferee respectively. The transferor sacrifices future economic benefits in the form of a reduction in assets that results in a decrease in equity. Receipt of the transfer by the transferee does not give rise to a liability of that entity, and therefore constitutes an inflow of future economic benefits in the form of an increase in assets that results in an increase in equity. The nature of non-reciprocal transfers is discussed in paragraphs 100 to 105. The collection of cash from debtors does not of itself give rise to revenues or expenses. Where the amounts collected from debtors differ from their carrying amounts prior to collection, the difference between those amounts constitutes a revenue or an expense arising from a change in the future economic benefits embodied in the debtors, and does not result from the exchange of the obligations to the entity for cash.

124 Certain increases in equity and reductions in equity do not qualify as revenues or expenses. These include those resulting from contributions by owners and distributions to owners, and those occurring under certain accounting models in the form of measurement adjustments, which are discussed in paragraphs 147 and 148.

Criteria for Recognition of Revenues

125 **A revenue should be recognised in the operating statement, in the determination of the result for the reporting period, when and only when:**

(a) it is probable that the inflow or other enhancement or saving in outflows of future economic benefits has occurred; and

(b) the inflow or other enhancement or saving in outflows of future economic benefits can be measured reliably.

Probable inflow or other enhancement or saving in outflows of future economic benefits

126 For a revenue to qualify for recognition, it must be probable that the inflow or other enhancement or saving in outflows of future economic benefits has occurred. The term "probable" means that the chance of the inflow or other enhancement or saving in outflows of future economic benefits having occurred is more likely rather than less likely.

127 The probability of such inflows or other enhancements or savings in outflows of future economic benefits will vary. Assessments of the degree of certainty attaching to the inflows or other enhancements or savings in outflows of future economic benefits in any particular situation should be made on the basis of available evidence. For many entities, the majority of revenues will result from the provision of goods and services during the reporting period and the large majority of underlying transactions and other events will involve little or no uncertainty that an inflow or other enhancement or saving in outflows of future economic benefits has occurred, since the entity will either have received cash or have an explicit claim against an external party. However, an absence of an exchange transaction will often raise doubts about whether the requisite degree of certainty has been attained. In situations where there is uncertainty about the inflow or other enhancement or saving in outflows of future economic benefits and the other criterion for the recognition of revenues is satisfied, revenues would qualify for recognition when the inflow or other enhancement or saving in outflows is probable.

Reliable measurement

128 For an item of revenue to qualify for recognition it is also necessary that the inflow or other enhancement or saving in outflows of future economic benefits can be measured reliably. In most cases the inflow or other enhancement or saving in outflows of future economic benefits will be clearly evident and will be capable of measurement with a high degree of reliability. However, in some cases the inflow or other enhancement or saving in outflows of future economic benefits will be the subject of estimates. For example, in accounting for construction contracts the stage of contract completion and/or the amount of revenues that will ultimately be recognised can be uncertain and would need to be estimated. In such cases, revenues would qualify for recognition only if the inflow or other enhancement or saving in outflows of future economic benefits can be measured reliably.

Impact of the measurement model adopted

129 The measurement model adopted and its underlying concepts of capital and capital maintenance are relevant to the timing of the recognition of revenues. For example, in an historical cost model assets are measured in terms of the nominal dollars that it cost to acquire the future economic benefits comprising those assets. Although an increase in the value of assets held, measured for example by reference to market selling prices, could be considered to represent an enhancement of future economic benefits and, therefore, an item of revenue, the increase in value is not normally recognised until the assets are sold and there is an inflow of future economic benefits in the form of the proceeds from sale or a claim thereto. This is because the historical cost model is transaction based and the occurrence of a transaction with an external party (a sale) is normally considered to be a necessary condition for the enhancement in an asset's value to be recognised as an item of revenue. In contrast, in an exit price model, the enhancement of future economic benefits in the form of increased market selling prices of assets held by the entity is recognised as prices change. Under that model, revenues do not arise upon sale of the assets, as the sales reflect an exchange of assets of the same value in terms of command over current cash equivalents. Under some measurement models, recognised increases in the value of assets generally would not be recognised as revenues because the increases in value are not identified as enhancements of future economic benefits. Instead, they would be recognised as direct adjustments to the amount of equity. These adjustments are discussed in paragraph 148.

Transaction-based models for revenue recognition

130 Under transaction-based accounting models, it would not be possible to specify detailed tests which, for any entity, would identify the appropriate point at which revenues from the provision of goods and services should be recognised. However, consideration of the following tests will be useful in many situations in identifying whether, for a transaction involving the provision of goods or services, it would be probable that an inflow of future economic benefits will have occurred and will be capable of being measured reliably:

(a) an agreement for the provision of the goods or services exists between the entity and one or more parties external to the entity;

(b) cash has been received, or the entity has a claim against an external party or parties that:

(i) is for a specified consideration, in the form of cash, other assets, or a reduction in a liability of the entity; and

(ii) cannot be avoided by the external party or parties without the incurrence of a penalty set sufficiently large as, in normal circumstances, to deter avoidance;

(c) all acts of performance necessary to establish a valid claim against the external party or parties have been completed; and

(d) it is possible to estimate reliably the collectability of debts or the return of the goods sold.

131 Where all of these tests are met, the definition and recognition criteria for revenues will be satisfied, because it will be probable that an inflow of future economic benefits has occurred in respect of the entity's acts of performance and because the future economic benefits that have been, or will be, received can be measured reliably. However, there will be situations where the criteria for recognition of revenues will be considered to have been met even though one or more of the tests identified in paragraph 130 have not been satisfied.

Criteria for Recognition of Expenses

132 **An expense should be recognised in the operating statement, in the determination of the result for the reporting period, when and only when:**

(a) it is probable that the consumption or loss of future economic benefits resulting in a reduction in assets and/or an increase in liabilities has occurred; and

(b) the consumption or loss of future economic benefits can be measured reliably.

Probable consumption or loss of future economic benefits

133 For an expense to qualify for recognition, it must be probable that the consumption or loss of future economic benefits has occurred. The term "probable" means that the chance of the consumption or loss of future economic benefits having occurred is more likely rather than less likely.

134 The probability of such consumption or loss of future economic benefits will vary. Most expenses result from the production or

delivery of goods and services during the reporting period and the large majority of these involve little or no uncertainty that future economic benefits have been consumed; for example, cost of goods sold, cost of employee services, supplies used and equipment used. However, in some cases there will be uncertainty as to whether there has been a consumption or loss of future economic benefits during the reporting period; for example, it may be difficult to determine whether the future economic benefits embodied in long-lived assets have suffered commercial impairment (in addition to physical wear and tear) during the reporting period. In situations where there is uncertainty about the consumption or loss of future economic benefits, expenses would qualify for recognition when the consumption or loss is probable.

Reliable measurement

135 For an expense to qualify for recognition it is also necessary that the consumption or loss of future economic benefits can be measured reliably. In most cases the consumption or loss of future economic benefits will be clearly evident and will be capable of measurement with a high degree of reliability. However, in some cases the consumption or loss of future economic benefits will be the subject of estimates; for example, the expected loss of future economic benefits resulting from outstanding litigation against the entity. In such cases, an expense would qualify for recognition if the consumption or loss of future economic benefits can be measured reliably.

Recognition techniques

136 Application of the recognition criteria specified in paragraph 132 usually involves identifying the consumption of future economic benefits during the reporting period in the process of providing goods and services.

137 Where future economic benefits acquired by the entity are consumed simultaneously with, or soon after, acquisition, expenses would qualify for recognition in the reporting period in which acquisition of the future economic benefits occurs. This means, in effect, that expenses would qualify for recognition in the reporting period in which the payment of cash occurs or, where payment is delayed, the liability for future payment is first recognised. In this latter case, measurement of the liability and the expense may involve a process of estimation. This technique would apply to many expenses; for example, employee remuneration, power and telecommunications.

138 Where expenses result directly and jointly from the same transactions or other events as do revenues – for example, cost of goods sold or

cost of services provided during the reporting period – expenses should be recognised on the basis of a direct association with revenues. This recognition technique is sometimes referred to as matching of expenses and revenues. It involves simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events. This technique can be readily applied by profit-seeking entities and those not-for-profit entities that generate revenues from the provision of goods and services. However, the technique is not as readily applicable to those transactions of not-for-profit entities that involve the provision of goods and services free of charge. Nevertheless, a similar technique can be adopted by these entities in that where expenses that result from the provision of particular goods and services free of charge can be identified, they should be recognised on the basis of an association with the provision of goods and services. In that sense, a "matching" of these expenses with the provision of the goods and services can be achieved.

139 Where future economic benefits are expected to be consumed over several reporting periods, expenses should be allocated systematically to the reporting periods during which the future economic benefits are expected to be consumed. This is often necessary in recognising the expenses associated with the using up of assets such as buildings, plant and equipment, goodwill, patents and trademarks.

Display of Revenues and Expenses

140 The concept of revenues is concerned with gross inflows of future economic benefits and savings in outflows of future economic benefits. Similarly, the concept of expenses is concerned with gross consumptions or losses of future economic benefits. As such, the concepts of revenues and expenses include items that may in practice be displayed in operating statements as "gains" or "losses". These items include, for example, gains and losses on foreign currency transactions, gains and losses on the settlement of liabilities, gains and losses on the disposal of assets, losses resulting from write-downs of assets to recoverable amount and losses resulting from natural disasters such as fire and flood. Some of these items, such as gains and losses on the disposal of assets, comprise revenues and expenses, namely the total increase in future economic benefits (revenues), in the form of the proceeds from disposal of the assets, and the total reduction in future economic benefits (expenses), which is the carrying amount of the assets at the time of disposal. Items reported in operating statements as gains and losses comprise revenues or expenses or a combination of both (in which case the revenues and expenses would relate to the same transaction or other event), and

therefore do not constitute elements of financial statements which are separate from revenues and expenses.

141 The manner in which revenues and expenses are presented in the operating statement and notes in the financial report is important to assessments of the performance of the entity. It may be useful to users if particular revenues and expenses are presented jointly; for example, as "gains" or "losses". In addition, it may be useful to distinguish revenues and expenses resulting from the entity's major or central operations and those resulting from other operations. These are matters of display which, although important to assessments of performance, are beyond the scope of this Statement.

142 In respect of the operating statement, this Statement is concerned with the definition of its constituent elements and the criteria for recognition of those elements. The definitions of revenues and expenses set out in this Statement are compatible with a range of presentation methods.

OTHER CHANGES IN EQUITY

143 Other changes in an entity's equity include non-reciprocal transfers to and from owners (distributions to owners and contributions by owners).

Contributions by Owners and Distributions to Owners

Definitions

144 **"Contributions by owners" means future economic benefits that have been contributed to the entity by parties external to the entity, other than those which result in liabilities of the entity, that give rise to a financial interest in the net assets of the entity which:**

- **(a) conveys entitlement both to distributions of future economic benefits by the entity during its life, such distributions being at the discretion of the ownership group or its representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or**

- **(b) can be sold, transferred or redeemed;**

"distributions to owners" means future economic benefits distributed by the entity to all or part of its ownership group, either as a return on investment or as a return of investment; and

"ownership group" means the group comprising those parties with a financial interest in the net assets of the entity which have obtained that interest by contributing future economic benefits to the entity in the form of contributions by owners or by acquiring the interest, established at an earlier time as a result of contributions by owners, from another party.

Nature of Contributions by Owners and Distributions to Owners

145 Contributions by owners and distributions to owners are non-reciprocal transfers between an entity and its owners acting in their capacity as owners. Contributions by owners will usually be in the form of cash, but may also be in the form of non-monetary assets, such as property, plant and equipment, or the provision of services. In some instances, the contribution is made in the form of the conversion of liabilities of the entity into equity.

146 Reductions in equity as a result of distributions to owners can be in the form of the transfer of assets, the rendering of services or the incurrence of liabilities. Distributions to owners are made at the discretion of the ownership group or its representatives after satisfying restrictions imposed by legislation or by agreements with other entities. Generally, an entity is not obliged to transfer assets to owners except in the event of the entity being wound up, unless the entity formally acts to distribute assets to owners by, for example, declaring a dividend. In this event, a liability to pay dividends would be recognised by the entity, which would have the effect of reducing equity.

MEASUREMENT MODEL

147 This Statement is not premised on the adoption of a particular measurement model. Application of the concepts in this Statement does not imply that assets or liabilities would be revalued. In addition, if assets or liabilities are revalued, application of the concepts in this Statement does not imply that the changes in the values of assets or liabilities would be recognised as revenues and expenses. These considerations depend on the measurement model adopted. A Statement of Accounting Concepts on measurement of the elements of financial statements will address the fundamental issue of measurement models.

148 The concepts of capital and capital maintenance adopted, and the measurement basis employed to make those concepts operational, would determine *inter alia* the extent to which any increase or decrease in the measured amount of an asset is identified as an enhancement or loss of future economic benefits and thus an item of revenue or expense. For example, adoption of the concepts of physical capital and physical capital maintenance would result in changes in the specific prices of productive assets held by the entity during the reporting period being recognised as changes in value which do not constitute enhancements or losses of future economic benefits. Accordingly, those changes would be recognised as direct adjustments to the amount of equity, and not as revenues or expenses.

COMPATIBILITY WITH IASC, NEW ZEALAND AND OTHER OVERSEAS FRAMEWORKS

International

The accounting concepts set out in this Statement are generally consistent with those set out in the Framework for the Preparation and Presentation of Financial Statements issued by the International Accounting Standards Committee (IASC), insofar as that Framework addresses the definition and recognition of the elements of financial statements. This Statement applies to all reporting entities in the public and private sectors, whereas the IASC Framework does not apply to non-business entities in the public and private sectors.

New Zealand

The accounting concepts set out in this Statement are generally consistent with those set out in the Statement of Concepts for General Purpose Financial Reporting issued by the New Zealand Society of Accountants, insofar as that Statement addresses the definition and recognition of the elements of financial statements.

Other Overseas Frameworks

The accounting concepts set out in this Statement are generally consistent with those set out in the final or draft Conceptual Frameworks issued by the Financial Accounting Standards Board (United States of America), The

Canadian Institute of Chartered Accountants, the Accounting Standards Board (United Kingdom) and The South African Institute of Chartered Accountants, insofar as those Statements address the definition and recognition of the elements of financial statements.

A detailed comparison of this Statement with corresponding Statements issued in overseas jurisdictions is set out in the attached document entitled "Background and Basis for Conclusions".

BACKGROUND AND BASIS FOR CONCLUSIONS

CONTENTS

BACKGROUND AND BASIS FOR CONCLUSIONS

Place in the Conceptual Framework

A1 Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements" constitutes building blocks 5 and 6 of the conceptual framework for general purpose financial reporting in the public and private sectors which is being developed by the Australian Accounting Standards Board (AASB) and the Public Sector Accounting Standards Board (PSASB). A diagram of the framework is set out as Figure 1 on the next page. The framework will comprise a series of Statements of Accounting Concepts ("Concepts Statements") which set out the concepts which have been adopted by the Boards in respect of the nature, subject, purpose and broad content of general purpose financial reporting. Three Statements have been issued previously. These Statements (set out below) were issued in August 1990 :

SAC 1 "Definition of the Reporting Entity";

SAC 2 "Objective of General Purpose Financial Reporting"; and

SAC 3 "Qualitative Characteristics of Financial Information".

A2 Components of the framework which will be completed in the future are the definition of financial reporting; basis and techniques of measurement; display of information about performance, financial position, changes in financial position, and compliance; standard-setting policy and enforcement. These components of the framework are outlined in Policy Statement 5 "The Nature and Purpose of Statements of Accounting Concepts", prepared by the AASB and PSASB and issued in March 1995.

Development of the Statement

The Superseded Statement

A3 Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements" as issued in March 1992 is superseded by this Statement. The superseded Statement was based on the following five exposure drafts and the comments received in response thereto:

ED 42C "Definition and Recognition of Assets" (December 1987);

ED 42D "Definition and Recognition of Liabilities" (December 1987);

ED 46B "Definition and Recognition of Expenses" (April 1988);

ED 51A "Definition of Equity" (August 1990); and

ED 51B "Definition and Recognition of Revenues" (August 1990).

A4 In addition to exposure of the abovenamed exposure drafts for public comment, the steps followed in the due process for development of the superseded Statement included:

(a) publication of the following accounting theory monographs:

(i) The Definition and Recognition of Revenue (No. 3, 1982);

(ii) The Definition and Recognition of Liabilities (No. 4, 1984);

(iii) The Definition and Recognition of Assets (No. 7, 1988); and

(iv) The Concept of Equity in Financial Accounting (No. 9, 1989); and

(b) conducting a series of one-day conceptual framework seminars in six capital cities.

A5 The superseded Statement was consistent in all significant respects with the five abovenamed exposure drafts.

The Reissued Statement

A6 An extensive consultative process was undertaken by the AASB and PSASB following issuance of the superseded Statement. Amongst other initiatives, this included the conduct of a series of nine seminars held in the capital cities from October 1992 to March 1993, and publication of articles in *AARF Report No. 12* and *AARF & AASB Report No. 16*.

A7 Based on feedback received from constituents concerning the concepts and guidance in the superseded Statement, and on practical application of those concepts, the AASB and PSASB issued a media release on 11 December 1992 which:

(a) announced deferral of the operative date of SAC 4 from 1 January 1994 to 30 June 1995 (with requirements concerning recognition of agreements equally proportionately unperformed deferred until 30 June 1996); and

(b) invited public comment on SAC 4 by 30 April 1993.

A8 More than one hundred submissions were received by June 1993. The Boards considered those submissions in the development of the reissued Statement. An outline of significant issues raised by constituents in respect of the concepts in SAC 4, and the Boards' decisions in respect of those issues (including a summary of significant changes to the superseded Statement), is set out later in this document.

A9 In finalising the reissued Statement, the AASB and PSASB discussed the draft reissued Statement with a wide range of interest groups.

Changes to Superseded Statement

A10 The main changes to the superseded Statement are set out below:

(a) *Service potential*

The expression "service potential" has been omitted from the definitions and recognition criteria. As is noted in paragraph 18 of this Statement, the characteristic of future economic benefits is synonymous with the notion of service potential, a term which is used more commonly in respect of not-for-profit entities. The expression "future economic benefits" has sometimes been used in accounting texts to signify access to future cash inflows. However, the term is used in the Statement with a broader meaning – namely, the capacity to provide goods and services in accordance with the entity's objectives, whether those objectives are the generation of net cash inflows or the provision of goods and services of a particular volume and quality to beneficiaries. This amendment has been made so as to simplify the expression used in the Statement, and does not change the intended meaning of the definitions and recognition criteria.

(b) *Omission of transitional provisions*

The transitional provisions have been omitted. These provisions required adjustments resulting from initial application of the Statement to be adjusted against retained profits (surplus) or accumulated losses (deficiency) when the Statement is first applied. The Boards agreed with comments that retention of the transitional provisions would be inappropriate in view of the non-mandatory status of Statements of Accounting Concepts enunciated in Professional Statement APS 1.

Except in the circumstances outlined below, changes in accounting policies which result from adoption of concepts in the reissued Statement would need to be accounted for as giving rise to revenues or expenses. Accordingly, they would be accounted for in a similar manner to other changes in accounting policy which do not result from initial adoption of Accounting Standards. An exception to this approach would arise where there is a statutory requirement to change an accounting policy with the effect that particular concepts in the reissued Statement are adopted, and the statutory requirement specifies the making of an initial accounting entry to give retroactive effect to the changed accounting policy. In such an instance, any resulting revenue or expense would, consistent with paragraph 15 of Australian Accounting Standard AAS 1 "Profit and Loss or other Operating Statements" and paragraph 11 of Accounting Standard AASB 1018: Profit and Loss Accounts, need to be adjusted directly against retained profits (surplus) or accumulated losses (deficiency).

(c) *Changes to commentary*

The following commentary has been added so as to clarify further the meaning of particular concepts:

(i) paragraph 52 notes that it is not necessary that the identity of the party to whom an obligation is owed be known in order for a present obligation to exist;

(ii) paragraph 53 notes that the party to whom a present obligation is owed may differ from the party or parties which will receive goods or services as satisfaction of the obligation;

(iii) paragraph 60 notes that recognition of the need to make future expenditures on overhauls, repairs and renewals of property, plant and equipment as a result of operations prior to the reporting date would be effected by the recognition of an appropriate amount of depreciation;

(iv) paragraph 62, which provides commentary on the characteristics of liabilities, notes that the future sacrifices of economic benefits that an entity is obliged to make to other entities may be in various forms. These may range from the payment of cash to the using up of plant, equipment and consumable stores in the provision of goods and services. The paragraph emphasises that the form in which economic benefits are sacrificed does not determine the basis or bases on which liabilities would be measured, that issue being beyond the scope of the Statement;

(v) paragraphs 72 to 75 explain the circumstances in which application of the definitions and recognition criteria for assets and liabilities would result in discontinued recognition of assets and liabilities. Those paragraphs do not address the classification (for example, as revenues or expenses) of accounting entries which reflect the discontinued recognition, or subsequent reinstatement, of assets and liabilities because the appropriate classification will depend on the circumstances;

(vi) paragraphs 101 to 105 elaborate on the characteristics of reciprocal and non-reciprocal transfers, to explain whether an inflow of future economic benefits gives rise to a liability or an increase in equity; and

(vii) paragraph 129 indicates that under some accounting models, recognised increases in the value of assets would not be identified as enhancements of future economic benefits. Therefore, they would be recognised as direct adjustments to the amount of equity (such as additions to revaluation reserves) rather than as revenues.

Former commentary paragraph 131, concerning the nature of dividends, has been omitted. Interested parties had indicated that the paragraph did not assist their understanding of the nature of distributions to owners.

(d) *Omission of operative date*

The reissued Statement does not specify an operative date. The Boards are of the view that operative dates are inappropriate for Statements of Accounting Concepts. The Statement is effectively operative as a guide to the Boards in addressing accounting issues, immediately upon its finalisation by the Boards.

(e) *Omission of former Appendix*

The Appendix to the superseded Statement has been omitted from the reissued Statement. The Appendix provided guidance on some applications of the concepts set out in the superseded Statement to particular accounting issues, and explored the implications of those concepts for some reporting practices applied by a number of entities prior to the issuance of that Statement. Commentators on the superseded Statement had argued that the inclusion of detailed interpretations in the superseded Statement was inappropriate. In their view, those interpretations were unnecessary for a Statement setting out broad concepts, and some of the interpretations were not appropriate for the range of transactions to which they could potentially be applied. The Boards are of the view that retention of the detailed interpretations would be inappropriate for a Statement which sets out broad concepts, and that any detailed interpretations of particular concepts which are not integral to explaining the meaning of those concepts should be included in Accounting Standards and other documents issued by the Boards.

Comparison with Overseas Frameworks

A11 The following discussion compares this Statement with final or draft conceptual framework statements issued in overseas jurisdictions. Those jurisdictions and statements are:

United States of America	Statements of Financial Accounting Concepts No. 5 "Recognition and Measurement in Financial Statements of Business Enterprises" (SFAC 5) and No. 6 "Elements of Financial Statements" (SFAC 6), issued by the Financial Accounting Standards Board (FASB) in December 1984 and December 1985[1] respectively;
International Accounting Standards Committee (IASC)	Framework for the Preparation and Presentation of Financial Statements, issued in July 1989;
South Africa	Section AC 000 (Framework for the Preparation and Presentation of Financial Statements) of the Members' Handbook of The South African Institute of Chartered Accountants, issued in November 1990;
Canada	Section 1000 ("Financial Statement Concepts") of the Recommendations of The Canadian Institute of Chartered Accountants (CICA), issued in March 1991;
New Zealand	Statement of Concepts for General Purpose Financial Reporting, issued by the New Zealand Society of Accountants in June 1993; and
United Kingdom	Chapter 3 ("The elements of financial statements") and Chapter 4 ("The recognition of items in financial statements") of the Draft Statement of Principles issued for comment by the Accounting Standards Board in July 1992.

A12 The concepts in this Statement are similar to those set out in the abovenamed overseas Concepts Statements. This is evidenced by the comparison of the definitions and recognition criteria set out in the attached table. The Boards regard international compatibility as an important feature of a conceptual framework. The similarities between the concepts in SAC 4 and those in overseas frameworks underpin the Boards' decision to substantially retain the concepts set out in the superseded Statement.

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1 SFAC 6 was issued as a replacement Statement for Statement of Financial Accounting Concepts No. 3 "Elements of Financial Statements of Business Enterprises", which was issued in December 1980.

A13 Nevertheless, there exist some differences between this Statement and overseas Concepts Statements. The more significant differences are outlined below.

Definitions of Gains and Losses

A14 In some jurisdictions, gains and losses have been defined as elements separate from revenues and expenses. A comparison of this Statement with overseas frameworks in this regard follows:

(a) consistent with SAC 4, the New Zealand, South African and IASC frameworks have defined revenues (or "income") and expenses to encompass gains and losses, with reporting of the latter items being treated as a matter of display (that is, nothing in those definitions precludes revenues and expenses from being presented on a net basis);

(b) the United Kingdom framework has defined gains and losses to encompass revenues and expenses. The difference in terminology between gains and revenues, and losses and expenses, is treated as a matter of display only; and

(c) the United States and Canadian frameworks define revenues and expenses separately from gains and losses. In both jurisdictions, revenues and expenses are defined as arising from the entity's central or ordinary operations. Gains and losses are, effectively, all other increases and decreases in equity[2] that do not arise from transactions with owners acting in their capacity as owners.

A15 The defining of gains and losses separately from revenues and expenses was formally considered by the AASB and PSASB in the preparation and review of the superseded Statement. The approach was not supported by the Boards, primarily because of the difficulties of consistently distinguishing inflows and outflows from "ordinary" or "central" operations (such as production or sale of inventories, rendering of services and the provision of finance) from inflows and outflows (such as purchase of plant, collections from debtors and receipt of borrowings) which are not "central" but nevertheless are often essential to the operations of the entity. Being a matter of

[2] The United States and Canadian frameworks each define gains as "increases in equity ... except those that result from revenues...", and define losses as "decreases in equity ... except those that result from expenses...". Therefore, those frameworks identify revenues and expenses as elements that result in increases in equity and decreases in equity, respectively.

display, the presentation of revenues and expenses jointly as "gains" and "losses" is compatible with the concepts in this Statement. This display issue will be the subject of a Statement of Accounting Concepts on the display of performance.

Concept of Equity

A16 Equity is defined as a residual in this Statement and in the IASC, New Zealand, South African and United States (FASB) frameworks. Equity is defined as an ownership interest in the United Kingdom and Canadian frameworks.

A17 Defining equity as a residual avoids any need to distinguish, at a definitional level, between equity of profit-seeking entities and net assets of not-for-profit entities. It enables a single set of concepts to be applied to all entities. In addition, each of the overseas frameworks is substantially similar to this Statement in the way they define assets and liabilities, and in the identification of equity as a residual (whether or not it is defined as a residual). Accordingly, the meaning of the definition of equity in this Statement and the definitions of equity in overseas frameworks is substantially similar, notwithstanding the differences in expression.

A18 For these reasons, the Boards decided to retain the definition of equity as a residual in the reissued Statement.

A19 Concerns have been expressed in submissions on the superseded Statement about the implications of a residual definition of equity for the identification of different interests in the net assets of an entity. The definition of equity in this Statement is neutral in this regard. Various methods of display of the components of equity may be adopted. The issue of the display of components of equity will be the subject of a Statement of Accounting Concepts on the display of financial position.

A20 FASB Concepts Statement No. 6 (SFAC 6) contrasts "net assets" of not-for-profit organisations with "equity" of a business enterprise, in that the former "is not an ownership interest" (paragraph 90). However, SFAC 6 defines net assets of a not-for-profit organisation in the same words as equity, that is, as a residual. In addition, the commentary in SFAC 6 does not imply that the existence or amount of equity of business enterprises would be identified in a different manner than would equity of not-for-profit organisations. Accordingly, the differences between SFAC 6 and SAC 4 (which uses "equity" as the term corresponding to net assets of all entities) relate only to terminology.

A21 The Canadian Concepts Statement defines "net assets" for non-profit organisations, but notes that this is also described as equity. The New Zealand, IASC, South African and United Kingdom Concepts Statements define equity without distinguishing it from "net assets", although it should be noted that the latter three of those frameworks were developed for business entities only.

General Recognition Criteria

A22 The criteria for recognition of an element are substantially similar but structured differently among the frameworks. The FASB's recognition criteria differ from other frameworks by referring specifically to relevance, which is implicit in the definitions of the elements.

A23 A difference of expression between the structure of the definitions and recognition criteria in the various frameworks is that the FASB, IASC and South African frameworks refer to "expected" or "probable" future benefits/sacrifices in the *definitions*. The IASC and South African frameworks also refer to "probable" in their recognition criteria. The difference in the FASB, IASC and South African wording is not understood to connote a significant difference in meaning from that in the Australian, New Zealand and United Kingdom definitions. The Canadian definitions refer to benefits which may be obtained/transferred. This is consistent with the definitions in this Statement, and substantially similar to the FASB, IASC and South African definitions. In respect of the FASB's framework, this view is supported by the following comments in paragraph 47 of SFAC 6:

> "The degree of probability of a future economic benefit ... (is a) matter of recognition and measurement that (is) beyond the scope of this Statement.[3] ... Matters involving ... effects of uncertainty ... may be significant in applying a definition, but they are not part of the definition."

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3 That is, it falls within the scope of Statement of Financial Accounting Concepts No. 5 "Recognition and Measurement in Financial Statements of Business Enterprises".

Recognition of Revenues

A24 Although virtually all of the oversea s frameworks adopt probability as a general criterion for the recognition of an element [4], most of those frameworks include a more stringent requirement or more stringent guidance that would be applied in practice to the recognition of revenues or their equivalent. This is because of views that the recognition criteria need to be applied prudently, especially in respect of revenues; and because some of those Concepts Statements attempt to establish the implicit links between the concepts specified therein and historical practices.

A25 For example, FASB Concepts Statement No. 5 states that:

> "... as a reaction to uncertainty, more stringent requirements historically have been imposed for recognizing revenues and gains than for recognizing expenses and losses, and those conservative reactions influence the guidance for applying the recognition criteria to components of earnings" (paragraph 81).

A26 Chapter 4 of the United Kingdom Accounting Standards Board's Discussion Draft Statement of Principles includes the following commentary:

> "*In dealing with uncertainty, prudence requires more persuasive evidence (of both occurrence and amount) for the recognition of items that result in an increase in equity than for the recognition of items that do not.* ... However, the exercise of prudence does not allow for the omission of assets or gains where there is sufficient evidence of occurrence and reliability of measurement, or for the inclusion of liabilities or losses where there is not. This would amount to the deliberate understatement of assets or gains, or the deliberate overstatement of liabilities or losses." (paragraph 24)

A27 The frameworks of the IASC, the FASB, the United Kingdom Accounting Standards Board, the South African Institute and CICA indicate that in applying the general recognition criteria, revenues or their equivalent would need to be "earned" or "realised" (or that "performance" would need to have occurred) before they qualify for recognition in the operating statement. Those frameworks generally

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4 Chapter 4 of the United Kingdom Accounting Standards Board's Disc ussion Draft Statement of Principles uses the term "sufficient evidence" rather than "probable benefit/sacrifice" in its general recognition criteria (paragraph 4).

do not define those terms. However, Chapter 4 of the draft United Kingdom framework states that:

> "gains[5] ... must have been earned – i.e. they must not belong to a future period (and) ... *there is no material transaction, contract or other event that must occur before the change in the assets or liabilities of the entity inherent in the gain will have occurred*" (paragraph 55);

and FASB Concepts Statement No. 5 states that:

> "... recognition of revenues and gains ... involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.
>
> a. ... Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash ...
>
> b. ... An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no "earning process", and for recognizing gains, being earned is generally less significant than being realized or realizable." (paragraph 83)

A28 Chapter 4 of the draft United Kingdom framework also provides guidance on the meaning of "realised", in terms of either being measurable with sufficient reliability (which is consistent with the recognition criteria in SAC 4); resulting from a change in an asset or liability of a type not held for continuing use in the business and the resultant asset or liability is readily convertible to known amounts of cash or cash equivalents; or resulting from a liability expiring, being cancelled or otherwise ceasing to exist (paragraph 55(b)).

A29 This Statement includes commentary that is consistent with the general meaning of the abovementioned guidance in overseas frameworks. Paragraph 130 of this Statement sets out tests which

5 Gains are the equivalent concept to revenues in the draft United Kingdom framework.

will be useful in many situations in identifying whether, for a transaction involving the provision of goods and services, it would be probable that an inflow of future economic benefits will have occurred and will be capable of being measured reliably. Consistent with the explicit tests in some overseas frameworks, the tests set out in paragraph 130 include the completion of performance.

A30 These tests are set out as indicative criteria rather than as pre-requisites for an item to satisfy the criteria for recognition as revenues. However, submissions received on the superseded Statement included comments that notions of earnings, realisation and performance need to be elevated to the status of explicit recognition criteria, or that more stringent recognition criteria should be specified for the recognition of revenues.

A31 Consistent with the general recognition criteria adopted in the overseas frameworks, the reissued Statement retains the characteristic of symmetry between the recognition criteria for each element. The Boards chose not to adopt a conservative bias through establishment in this Statement of more stringent criteria for the recognition of revenues, for the following reasons:

(a) it would conflict with the qualitative characteris tic of reliability, which requires *inter alia* that financial information is neutral. Accordingly, it would conflict with the qualitative characteristics set out in SAC 3 and in overseas frameworks;

(b) it would conflict with the Boards' goal of balance between the quality of information reported in the statement of financial position and in the operating statement; and

(c) it would specify two-tier criteria for the recognition of assets and liabilities instead of the general criterion of probability. That is, the criteria for the recognition and derecognition of assets and liabilities would differ according to whether a revenue or expense is involved. Such an approach would add considerable complexity to the concepts and would be inconsistent with the recognition criteria in overseas frameworks. It would also conflict with the comments in paragraph 24 of Chapter 4 of the draft United Kingdom framework (quoted in paragraph A26).

A32 Specification of particular tests, such as a need for "realisatio n", so as to ensure prudent application of the recognition criteria for revenues may be ineffective or inappropriate because:

(a) it is difficult to specify tests that are appropriate for all revenues and all types of entity;

(b) of the lack of generally agreed or clearly understood notions of "earning" or "realisation";

(c) of the limitations of notions of "earning" or "realisation" in ensuring that revenues are not dependent on the outcome of unknown future events. For example, as is noted in paragraph A28 above, the draft United Kingdom framework indicates that "gains" on assets not held for continued use would be realised where the asset is readily convertible to known amounts of cash or cash equivalents at the reporting date. However, the entity may be exposed to the risk of subsequent losses arising from price changes (for example, on marketable securities) and to ongoing credit risk in respect of debtors. For reasons such as these, it is unlikely that any basis (that is, whether neutral or conservative) on which revenues are recognised would enable reported revenues and expenses to provide sufficient information for assessments of the entity's prospects. That is, information about the risks facing an entity is more likely to be useful to users if it is disclosed about the entity's assets by way of note, rather than by the non-recognition of revenues;

(d) pervasive criteria that revenues must be "earned" before they can qualify for recognition would be inappropriate for the recognition of contributions and other non-reciprocal transfers to not-for-profit entities. This is because notions of earning are not useful when applied to entities whose objective is not the generation of profit. In this regard, it is relevant that three of the five frameworks which require revenues to be "earned" or "realised" before they qualify for recognition[6] were developed for business entities only[7]; and

(e) recognition criteria based on "realisation" of revenues would pre-empt future decisions to be made in respect of measurement concepts, because they imply the exclusive application of transaction-based models for revenue recognition.

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6 Those are the frameworks of the IASC, South Africa and the United Kingdom.

7 The treatment of contributions is discussed in paragraphs A77-A94 below.

A33 While some types of revenue may be the subject of uncertainty regarding the outcome of unknown future events, practical difficulties also arise in applying the recognition criteria to the other elements. For example, it may be difficult to assess the recoverable amount of a non-current asset or the value of work in progress on a construction contract, in accordance with the measurement basis adopted by the entity, or to assess the depreciation expense in respect of long-lived assets. It would be inconsistent to establish different general concepts for the recognition of revenues so as to deal with the effects of uncertainty on the recognition of revenues, while disregarding the effect of uncertainty on the recognition of the other elements.

A34 To deal with the effects of uncertainty on the recognition of revenues, Accounting Standards may be developed which explain how a probable inflow of future economic benefits should be identified, or which specify that because of the difficulties of obtaining sufficient evidence for recognition of particular revenues, more stringent tests need to be met for their recognition. However, the Boards are of the view that it would be inappropriate to include these policy aspects in the general concepts for the recognition of revenues. To do so would pre-empt the Boards' due process in respect of particular issues. Moreover, it would impair the understandability of the general concepts and give rise to inconsistencies within the Statement.

A35 For these reasons, the Boards have decided to retain the recognition criteria for revenues from the superseded Statement, and to leave practical tests for revenue recognition to the domain of commentary and, where appropriate, Accounting Standards. The Boards are also of the view that the difference between this Statement and some overseas frameworks in this regard is a matter of emphasis rather than a fundamental difference.

Specific Issues

A36 The following discussion examines specific issues raised in submissions on the superseded Statement and other topical aspects of the Statement.

Performance

A37 For profit-seeking entities, a primary purpose of general purpose financial reports is the provision of relevant and reliable information about the profitability of the entity. Statement of Accounting Concepts SAC 2 "Objective of General Purpose Financial Reporting" states that in the case of profit-seeking entities, "investors and other resource providers will want to know whether the entity is operating profitably and generating favourable cash flows in the process, since their decisions relate to amounts, timing and uncertainties of expected cash flows" (paragraph 21).

A38 Although the relationship between profit of a profit-seeking entity and compensation received by owners is complex and often indirect, profit is the basic source of compensation to owners for providing equity or risk capital to such an entity. Profitable operations generate assets that can be distributed to owners or reinvested in the entity, and investors' expectations about both distributions to owners and reinvested profit may affect market prices of the entity's equity securities. Expectations that owners will be adequately compensated – that they will receive returns *on* their investments commensurate with their risks – are as necessary to attract equity capital to an entity as are expectations of wages and salaries to attract employees' services, expectations of repayments of borrowing with interest to attract borrowed funds, or expectations of payments on account to attract raw materials or merchandise.

A39 Some commentators have argued that the superseded Statement placed insufficient emphasis on the provision of information that is useful for assessing the profitability of profit-seeking entities. Concerns had been expressed that the superseded Statement was inconsistent with the matching of revenues and expenses, and that it placed a bias toward the statement of financial position. These aspects are discussed in paragraphs A40-A59.

Matching

Profit-seeking entities

A40 The reporting of relevant and reliable information about the profitability of a profit-seeking entity will typically involve the matching of revenues and expenses in an appropriate manner. This could include the following types of matching of revenues and expenses:

(a) matching of expenses with revenues wher e those items result directly and jointly from the same transactions or other events; for example, simultaneous recognition of sales and cost of goods sold, and recognition of project revenues arising from performance under construction contracts simultaneously with recognition of project expenses;

(b) matching of revenues with progressive performance by an entity over a period; for example, recognition of interest revenues by lenders over the period of credit, and recognition of insurance premiums by insurers over the period of risk; and

(c) matching of expenses with the entity's productive operations; for example, the systematic recognition of depreciation over the periods during which the entity consumes the future economic benefits embodied in its long-lived assets. Where expenses are not related directly to particular revenues, their recognition will largely be independent of the recognition of revenues. However, a matching of those expenses will occur in the sense that they will be recognised concurrently with revenues generated by the entity's operations in the reporting period.

A41 Matching of revenues and expenses in the ways outlined above is generally consistent with this Statement. Application of these matching techniques will sometimes result in "deferral" of items in the statement of financial position and subsequent recognition of revenues and/or expenses during the reporting periods to which they relate. Whether such deferrals are consistent with this Statement will depend on whether they meet the definitions of assets or liabilities and the criteria for their recognition. Some commentators on the superseded Statement had interpreted the Statement as generally precluding the deferral of prepayments made (such as rent or insurance paid in advance) or subscriptions received in advance, and as generally precluding provisioning for any future expenditures (such as "provisions" for employee entitlements and "provisions" for income tax). In fact, application of this Statement would involve recognition of these items as assets and liabilities where they satisfy the definitions and recognition criteria.

A42 While application of this Statement would generally give rise to matching of revenues and expenses, there would be instances where matching will not be achievable if relevant and reliable information is to be reported. For example, there could be instances where costs, such as research and development costs, are incurred in the expectation of future benefits but it is not possible, at the reporting date, to establish that it is probable that future economic benefits will eventuate. In those circumstances, the costs would be recognised as expenses prior to recognition of any revenues which eventually are generated by a successful outcome from the activity concerned.

A43 Although application of the concepts set out in this Statement would typically give rise to matching of revenues with expenses, this Statement does not employ a process of "matching" as a determinant of how or when the elements of financial statements should be identified and recognised. Adoption of "matching" as an overriding concept in the identification of the items which should be recognised in financial statements is incompatible with the explicit specification of the nature of each of the elements of financial statements and the circumstances in which those elements should be recognised. In effect, it would endorse the application of the frameworks implicit in the thinking of preparers in preference to an explicit framework.

A44 Some matching techniques smooth the effects of events of different reporting periods in a manner that reflects the preparer's view of the long-term performance of the entity and reduces the volatility of reported results, but which involves recognition in the statement of financial position of items which satisfy neither the definition of assets nor the definition of liabilities. These techniques are not consistent with this Statement. Examples of these items are deferred exchange losses, provisions for uninsured future losses (sometimes described as self-insurance provisions) and provisions for expected future losses on unprofitable business segments. Implicit in this notion of matching is a view that the operating statement should have primacy over the statement of financial position. However, the Boards are of the view that in order to achieve the objective of general purpose financial reporting, both the operating statement and the statement of financial position should provide relevant and reliable information. In addition, these allocations do not foster reliable reporting and confidence in the quality of financial reports, because:

(a) they cause operating statements to reflect the expectations of preparers rather than economic phenomena, and are inherently unverifiable;

(b) anticipated long-term trends in profitability or in other measures of performance can only be confirmed after a substantial period has elapsed and resource allocation decisions have already been made; and

(c) they may obscure the relative riskiness of different businesses.

Periodic reporting

A45 For the reasons outlined below, the periodic nature of reporting is a constraint on the extent to which revenues can be matched with expenses in conventional financial reports. The operating statement reports the financial performance of an entity during the reporting period. Users will frequently be concerned with the implications of revenues and expenses recognised during the reporting period for the likely financial performance of the entity in the future, particularly in respect of the core business or essential service-delivery operations of the entity. For profit-seeking entities, some users may be concerned with assessing "maintainable profits"; for not-for-profit entities, users may be concerned with assessing the likely costs of future services and recoveries of those costs in the form of revenues. An important role of operating statements is to confirm whether the entity has performed as expected and to assist users to refine their assessments of likely future performance.

A46 Despite the interdependence of the abovementioned predictive and confirmatory roles of operating statements, there is normally some tension between those roles. To meet the confirmatory information needs of users in the context of periodic reporting, operating statements report the effects of transactions and other events that occur within the reporting period, and exclude the expected effects of future transactions and other future events. These latter items are excluded irrespective of whether they are relevant to interpreting the implications of the current period's result for the entity's prospects, so that reliable information is reported to enable comparisons of performance between entities and between reporting periods. This constraint on the items which are reported in operating statements, and the inter-period variability of many entities' revenues and expenses, constrain the extent to which a "matching" of revenues and expenses can be achieved in conventional periodic reports.

A47 The following example illustrates the constraints of periodic reporting on the matching of revenues and expenses. An entity may recognise "unrealised" exchange gains or losses, based on changes in the spot rate price applicable to its foreign currency monetary items during the reporting period. Where, for example, the movements in spot rates which gave rise to recognition of the unrealised gains or losses reverse after the reporting date, the effect of the reversal would not be recognised until the next reporting period, because it is not an event of the current reporting period. Implicit in periodic reporting is the likely need for users to assess the implications of each period's reported result in the context of the results reported over a number of reporting periods.

A48 The tension between the predictive and confirmatory roles of operating statements discussed in paragraph A46 above can be reduced substantially through separate disclosure of revenues and expenses of differing character (such as unrealised losses on marketable securities held for sale, unusual and non-recurring items and restructuring charges). This can assist users in interpreting the implications of the transactions and other events recognised during the reporting period. Similarly, to maximise the usefulness of the operating statement to assessments of performance, it might be argued that greater emphasis should be given to results from continuing operations, results excluding corrections of errors and the effects of changes in accounting policy, and results before abnormal items. Identification of certain items as meeting the definitions and recognition criteria for revenues and expenses set out in this Statement does not necessarily imply that those items would need to be included in the "bottom line" or primary performance measure in the operating statement. The content and structure of operating statements will be addressed in the development of a Statement of Accounting Concepts on the display of performance.

Not-for-profit entities

A49 Not-for-profit entities have objectives which do not include the provision of goods or services at a profit, and users are likely to be interested in non-financial measures of performance in addition to the financial results reported by those entities. Users are likely to be interested in the volume and quality of services the entity provides and the entity's ability to continue to provide them. This will depend in part on the efficiency and effectiveness of the entity's use of the resources provided to it for the purpose of service delivery. Information relevant to these assessments is likely to include the cost of goods and services provided during the reporting period (expenses) and the nature and extent of the entity's recoveries of that cost through the generation of revenues.

A50 Matching would occur in the application of this Statement to operating statements of not-for-profit entities. For example, consistent with profit-seeking entities, not-for-profit entities would appropriately match expenses with the entity's productive operations; such as through the systematic recognition of depreciation over the periods during which the entity consumes the future economic benefits embodied in its long-lived assets.

A51 In addition, matching would occur where assets are consumed or liabilities incurred in the provision of services without charge and the cost of service delivery is recognised as services are provided. For example, matching would occur where the consumption of stores and supplies is recognised simultaneously with the related provision of services.

Balance sheet bias?

A52 It has been contended that the superseded Statement placed a bias toward the statement of financial position (or balance sheet) rather than the operating statement because:

(a) revenues and expenses were defined in terms of changes in assets and liabilities; and

(b) the requirement that an item needed to satisfy the definition of assets, liability or equity if it was to qualify for recognition in the statement of financial position would have precluded some deferrals that previously have been made so as to report the effect of certain events in the operating statement over a number of reporting periods.

A53 As is noted in paragraph A44, the Boards are of the view that in order to achieve the objective of general purpose financial reporting, both the operating statement and the statement of financial position should provide relevant and reliable information. The Boards have developed this Statement so as to give equal emphasis to each of these financial statements.

A54 Each of the elements of financial statements has been defined in terms of future economic benefits or sacrifices thereof. Revenues and expenses are defined in terms of changes in assets and liabilities. The existence of assets and liabilities is able to be confirmed at a point in time. This is not so for revenues and expenses. Defining revenues and expenses in terms of changes in assets and liabilities provides a framework for reporting those elements according to their economic substance, and limits the scope for bias, intentional or otherwise, in the reporting of revenues and expenses. Each of the overseas frameworks referred to above defines revenues and expenses (or their equivalent) in terms of changes in assets and liabilities.

A55 Defining revenues and expenses in this manner does not imply that changes in assets and liabilities would necessarily affect the determination of reported results. Depending on the nature of the measurement model adopted, changes in the value of assets may be recognised as direct adjustments to the amount of equity without, therefore, affecting the reported result. The topic of measurement will be the subject of a separate Statement of Accounting Concepts. In addition, there are various mechanisms that could be employed to display revenues and expenses in the operating statement so as to maximise the usefulness of that statement to assessments of performance (examples of these mechanisms are provided in paragraph A48).

A56 The usefulness of a financial report in reflecting the economic substance of an entity's operations depends not only on the basis on which the elements are defined and recognised, but also on the measurement basis applied to those elements and the manner in which they are presented in the financial report. This Statement has been structured in as neutral a style as possible to allow for a range of existing and potential future approaches to the measurement and display of financial information. However, its scope does not encompass those aspects and the Statement cannot, therefore, resolve all of the issues that impinge on reporting the commercial reality, or economic substance, of the entity's operations.

A57 Some commentators have argued that the superseded Statement implied the measurement of assets and liabilities at current market values with changes in those values included in reported results, and therefore that the Statement emphasised information about financial position to the detriment of information about performance. In addition, comments were made that the definition of liabilities in the superseded Statement would have required liabilities for unearned revenues to be measured in a manner that causes profit to be reported prior to performance by the entity. However, both this Statement and the superseded Statement are compatible with various measurement bases (for example, historical cost or any form of current value accounting) that may be adopted. Similarly, if assets or liabilities are revalued, the Statement does not identify whether the revaluation increments and decrements would be recognised as revenues and expenses, or as direct adjustments to equity (such as adjustments to asset revaluation reserves).

A58 As noted in paragraph A41, some commentators on the superseded Statement had interpreted the Statement as having generally precluded deferral of costs and provisioning for any future expenditures. However, where these items satisfy the definitions and recognition criteria for assets and liabilities, their recognition would be consistent with this Statement. Many accepted reporting practices directed at reporting the effects of transactions and other events in the reporting periods to which they relate would be consistent with this Statement. For example, commentary in this Statement identifies unearned revenue and warranty provisions as liabilities, with the result that related revenues and expenses qualify for recognition in a manner that reflects the periodic performance of the entity.

A59 Concomitant with the defining of revenues and expenses in terms of changes in assets and liabilities is the fact that application of the criteria for the recognition of assets and liabilities "drives" the application of the criteria for the recognition of revenues and expenses. For example, if an entity incurs costs during the reporting period and is unable, at the date of the expenditure, to establish that it is probable that future economic benefits will eventuate, the costs would not qualify for recognition as an asset as at that date. Rather, the costs would qualify for recognition as expenses, because they are probable consumptions or losses of future economic benefits resulting from a reduction in assets. Some may argue that whether it is probable that a consumption or loss of future economic benefits has occurred should be determined independently of whether related assets qualify for recognition. However, the view adopted by the Boards is that the recognition criteria for revenues and expenses cannot be applied independently of the recognition criteria for assets and liabilities if the operating statement and the statement of financial position are to appropriately link with each other.

Recognition Criterion of Probable Future Benefits or Probable Future Sacrifice of Benefits

A60 A number of submissions on the superseded Statement expressed concern about the general recognition criterion of probability. Views which were commonly expressed were that:

(a) assets and revenues should be recognised more conservatively than liabilities and expenses (for example, assets should be recognised when future benefits are virtually certain);

(b) determining whether an item is probable requires undue subjectivity; and

(c) classification of compound securities as equity or liabilities according to whether it is probable that a future sacrifice of economic benefits to the security holders will be required may result in reporting of unreliable information and the potential for particular securities to be reclassified between liabilities and equity a number of times.

A61 The Boards are of the view that the general recognition criteria for each element should be symmetrical. They chose not to adopt a conservative bias in the criteria for recognition of the elements, for the reasons outlined in the foregoing comparison of this Statement with overseas frameworks. The adoption of a conservative bias in the recognition of the elements should not be confused with the exercise of prudence when dealing with uncertainties in the process of recognition and measurement. The Boards support the exercise of prudence in the form of ensuring that sufficient evidence is obtained to establish whether an item is probable and to ensure that it is measured reliably.

A62 The subjectivity of assessments of whether an item satisfies the threshold for recognition will generally be inherent in the item. That is, were another threshold to be adopted – such as a criterion that benefits be "highly probable" or "virtually certain" – there would remain the practical difficulty of establishing whether particular items meet that recognition criterion. The Statement indicates that the term "probable" means that the chance that future economic benefits will eventuate, or that a future sacrifice of economic benefits will be required, is more likely rather than less likely. Some of those who provided comment on the superseded Statement expressed concern that the degree of precision required by the probability criterion for recognition of an element was impractical. However, this recognition criterion is not intended to connote that a degree of mathematical precision would be required for its application. This Statement includes commentary that the term "probable" is used in the Statement with its usual meaning and refers to that which can be expected on the basis of available evidence or logic.

A63 For the majority of items, normally it can be readily established whether it is probable that future benefits will eventuate or future sacrifices will be required; for example, in respect of property, plant and equipment, investments, prepayments and debtors, and in respect of loans, employee entitlements and bank overdraft. In a number of cases, the effects of uncertainty would affect the determination of an appropriate measure for an element rather than whether the probability recognition criterion is satisfied. For example, while for an entity there may be little doubt that property, plant and equipment will give rise to future benefits, it may be problematic to assess whether the carrying amount of those items will be recoverable from future net cash inflows.

A64 Although the definitions and recognition criteria for the elements of financial statements have been specified separately from concepts for measurement (which will be the subject of a future Statement of Accounting Concepts), in practice the distinction between recognition and measurement will often be blurred. For example, where it is probable but not beyond doubt that future economic benefits embodied in assets will eventuate, in practice the assets may be recognised at amounts less than their face value; for example, by "providing" for uncollectibility of a proportion of debtors. Such practices are a practical response to uncertainties regarding the eventuation of future benefits, and are consistent with this Statement, which is neutral in respect of measurement.

A65 The Boards have adopted the view that while the recognition criterion of probability is an appropriate concept for the elements in general, practical application of that concept may need to be varied in some Accounting Standards, so as to foster reliable and comparable reporting for items which are particularly subject to uncertainty. For example, Exposure Draft ED 59 "Financial Instruments" had proposed that the component parts of liability/equity compound financial instruments (such as debt securities that are convertible into ordinary shares) that are initially classified as liabilities by issuers would continue to be classified as liabilities whether or not the general probability criterion for recognition as a liability is satisfied, except when the next opportunity for conversion or redemption is within twelve months of the reporting date.

Exercise of Judgement

A66 In various instances, it will not be clear cut how the concepts set out in this Statement would be applied. Adoption of control (rather than legal ownership) as an essential characteristic of assets, and adoption of present obligation (rather than only legal obligation) as an essential characteristic of liabilities gives rise to a need to exercise judgement in areas of uncertainty when applying the concepts in this Statement. For example, in identifying liabilities, difficulties may be encountered in determining whether equitable or constructive obligations exist. The Boards are of the view that adoption of these broad economic notions in the definitions provides a basis for reporting more useful and comprehensive information about the entity, and should be more useful in reflecting substance over form.

A67 Application of the definitions and recognition criteria would also give rise to the need to resolve measurement issues in the preparation of financial reports. This would be particularly the case where types of assets and liabilities are recognised for the first time as a result of applying those concepts. The need to make these judgements in the absence of specified measurement concepts when applying the definitions and recognition criteria bears similarities to the need to resolve measurement issues in response to evolving industry practices. Nonetheless, numerous submissions on the superseded Statement indicated a concern that measurement concepts need to be developed to support the application of the Statement. The Boards have given priority to the development of a Statement of Accounting Concepts dealing with measurement.

Agreements Equally Proportionately Unperformed

A68 The Boards are of the view that recognition of assets and liabilities which arise from agreements which are equally proportionately unperformed is likely to be useful to users for making and evaluating decisions about the allocation of scarce resources. For example, information about those agreements is likely to be useful to assessments of matters such as the resources controlled by the entity, the financial structure of the entity, and in some cases the financial risks to which the entity is exposed. The usefulness of recognition of these assets and liabilities has been argued by the Accounting

Standards Board in the United Kingdom (in Chapter 4 of the Discussion Draft of its Statement of Principles [July 1992]) and by the Association for Investment Management and Research (AIMR), the peak representative body of users of corporate financial reports in the United States[8] (in a position paper entitled "Financial Reporting in the 1990s and Beyond" [December 1993]). A Research Report published by the FASB[9] has commented that some rights and obligations arising from agreements equally proportionately unperformed would in concept qualify for recognition as assets and liabilities. SFAC 6 provides implicit support for the recognition of assets and liabilities in respect of those agreements. It notes that estimated losses on purchase commitments are "the recorded part of a series of transactions and events that are mostly unrecorded" (paragraph 251), that they are "in concept a reduction of (an) asset" (paragraph 252) and that "If both the right to receive assets and the obligation to pay were recorded at the time of the purchase commitment, the nature of the loss and the valuation account that records it when the price falls would be clearly seen" (paragraph 252). In addition, the view that recognition of assets and liabilities arising from agreements which are equally proportionately unperformed is likely to be useful to users is supported by the Accounting Standards in Australia and in overseas jurisdictions which require recognition of assets and liabilities in respect of finance leases and foreign currency contracts.

A69 However, recognition of all assets and liabilities which arise from agreements equally proportionately unperformed and satisfy the criteria for recognition would represent a fundamental change to existing reporting practices in Australia and in overseas jurisdictions. In addition, many agreements which are equally proportionately unperformed may give rise to significant uncertainty as to whether the definitions and recognition criteria would be satisfied. Recognition of assets and liabilities arising from these agreements gives rise to measurement issues. Substantial difficulties may be encountered in determining a reliable and appropriate measure for assets and liabilities which may arise from these agreements. In addition, decisions about the relative measures for assets and liabilities which may be recognised in respect of particular agreements could affect the reported results of the entity's operations. Recognition of these assets and liabilities gives rise to issues of display (such as whether and, if so, when those items should be set

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8 The AIMR comprises the Institute of Chartered Financial Analysts and the Financial Analysts Federation.

9 "Recognition in Financial Statements: Underlying Concepts and Practical Conventions" (July 1982).

off against each other in the presentation of the statement of financial position) which, although beyond the scope of this Statement, would need to be addressed in practice. The Boards have yet to consider the stage(s) at which revenues and expenses should be recognised over the duration of these agreements, and the manner in which assets and liabilities arising from these agreements should be presented in the statement of financial position.

A70 The Boards support an evolution in reporting practices toward recognition of these assets and liabilities, supported by similar developments in overseas jurisdictions. This subject will be addressed by particular projects of the Boards, such as the development of Accounting Standards for financial instruments and the future review of Accounting Standards for construction contracts, leases and foreign currency translation.

Provisions for Overhauls, Repairs and Renewals

A71 Some commentators on the superseded Statement argued that it is appropriate for an entity to recognise as a liability provisions for overhauls, repairs and renewals of property, plant and equipment, with concomitant recognition of an expense. They argued that application of this policy ensures a proper matching of the costs arising from operations with the revenues for the reporting period, and reflects in reported liabilities the necessary expenditures which will arise in future periods as a result of operations prior to the reporting date. Many of those commentators expressed the view that the concept of liabilities in the superseded Statement is consistent with this approach.

A72 However, provisions for overhauls, repairs and renewals do not involve a present obligation to an external party, and therefore do not satisfy the definition of liabilities in this Statement and the superseded Statement. An obligation would normally only arise when the works were performed. This applies irrespective of whether future expenditures are necessary as a result of past transactions or other past events in order to meet the entity's operating objectives. For example, a profit-seeking entity's need to replace raw materials used in productive operations does not give rise to a liability unless there is a present obligation to an external party. Similarly, a not-for-profit entity's need to replace items of equipment or consumable stores which have been used up prior to the reporting date does not constitute a liability, even where the entity is obliged by legislation to maintain the provision of essential services with those assets.

A73 Some commentators on the superseded Statement expressed the view that the essential characteristic of a present obligation to an external party results in an unduly narrow concept of liabilities. However, if the concept of present obligation were not to be an essential characteristic of liabilities, a very wide and difficult to define range of "necessary" future sacrifices of economic benefits could satisfy the definition of liabilities. For example, in addition to provisions for overhauls, repairs and renewals, anticipated losses on unprofitable segments or on future restructurings, provisions for uninsured future losses, and commitments for intended future acquisitions of property, plant and equipment could satisfy the definition of liabilities. Reporting these items as liabilities would obscure the nature of information reported about financial position as at a particular date and about performance for particular reporting periods, and would impair the reliability and comparability of financial reports.

A74 The view of the Boards is supported by specific commentary in the FASB and United Kingdom frameworks. For example, paragraph 200 of SFAC 6 states that:

> "... Not all probable future sacrifices of economic benefits (assets) are liabilities of an entity. For example, an entity's need to replace merchandise sold or raw materials or equipment used up, no matter how pressing, does not by itself constitute a liability of the entity because no present obligation to another entity is present."

A75 Paragraph 30 of Chapter 3 of the draft United Kingdom framework states that:

> "... costs to be incurred in the future (for example, replacement or maintenance of plant) do not represent liabilities, unless the entity has an obligation to another party to incur the costs in question, or retains no discretion to avoid the expenditure. Such an obligation might arise under a contract for goods to be supplied or services performed."

A76 As is noted in paragraph 60 of this Statement, application of the concepts would result in recognition of the cost of using property, plant and equipment as depreciation expenses in respect of the future economic benefits embodied in existing components of property, plant and equipment as they are consumed. Each component would be depreciated over its useful life, rather than over the useful life of the structure to which it belongs. For example, an aircraft engine would be depreciated over its expected useful life, rather than over the life of the aircraft to which it belongs. The expenditures on overhauls, repairs and renewals of those components would then be recognised as additions to those structures in place of the fully depreciated components. In practice, recognition of expenses in respect of periodic overhauls, repairs and renewals when related expenditures are made would be compatible with this Statement, provided the effect is materially similar to the effect of applying these concepts.

Contributions

A77 The treatment of contributions to not-for-profit entities, such as donations, grants, appropriations, taxes, rates and membership fees, has been a vexed issue. The view adopted in the superseded Statement and reflected in paragraphs 90 to 91 and 98 to 108 of this Statement, concerning the application of the concepts to contributions, has been the subject of a range of comments. The following discussion explores the more frequently expressed concerns and sets out the Boards' response to those concerns.

A78 The issue essentially turns on whether these items are liabilities, revenues or equity. The view adopted in this Statement is that contributions do not meet the definition of liabilities, and that they should be accounted for as revenues except in the rare instances where the contributions are of the nature of contributions by owners, in which case they should be accounted for as contributions of equity.

Do contributions give rise to liabilities?

A79 Some commentators on the superseded Statement argued that where there exist strong fiduciary obligations resulting from undischarged restrictions over contributions received, a liability exists which corresponds in amount to the restricted resources. This argument was based on the view that the entity will need to sacrifice economic benefits to other parties in satisfying the conditions for retention of the contribution. However, a not-for-profit entity's fiduciary obligation to use assets to provide goods and services to consumers and beneficiaries does not, of itself, create a claim against the entity by an external party which will require a future sacrifice of economic benefits. For transfers to an entity to create a liability, the transfers would need to be reciprocal, whereby the transferor and the transferee directly receive and sacrifice approximately equal value. A crucial feature of reciprocal transfers is that the recipient entity gives value in exchange *directly* to the transferring entity. It is not sufficient for the transferring entity to receive value (or benefit) indirectly as a result of the transfer. Were non-reciprocal transfers also to be identified as giving rise to liabilities, all receipts of assets from external parties (whether from owners, customers, beneficiaries, donors or lenders) would need to be classified initially as liabilities.

For example, on this basis all contributions by members to professional associations, clubs and societies would be identified as giving rise to liabilities, as would all government grants, appropriations and taxes. Similarly, where a company raises share capital based on representations in a prospectus that it will develop and operate a new facility, it would need to identify the share issue as giving rise to a liability for its fiduciary obligation to sacrifice economic benefits in the future. In addition, because a not-for-profit entity's fiduciary obligation to use assets to provide goods and services to consumers and beneficiaries pertains to all of the entity's assets, were the existence of a fiduciary obligation to be identified as a sufficient condition for the existence of a liability, liabilities would need to be identified in respect of all of the entity's assets and there would be no equity.

A80 If the view is adopted that fiduciary obligations give rise to liabilities, but only where the obligations relate to explicit restrictions over contributions, a problem arises where contributions are restricted on the basis that they are to be expended on the acquisition of specified assets and that those assets would be used for service delivery on a continuing basis. If a liability were to be recognised for these fiduciary obligations, it would be difficult to identify when the liability should be derecognised. For example, not-for-profit entities are occasionally provided with "seed money" for the acquisition of long-lived assets on the condition that the assets are to be used for designated services and that they are to be replaced as they wear out. Expenditure of the money in the manner specified would not extinguish the fiduciary obligation of the recipient. If the entity's obligation to sacrifice economic benefits in satisfying the conditions attaching to the contribution were to be identified as a liability, notwithstanding that there does not presently exist a claim by a particular external party against the entity in respect of the contribution, it would appear that the "liability" would encompass:

(a) the amount to be expended on the acquisition of the assets;

(b) the amount to be sacrificed on the maintenance of the assets; and, possibly,

(c) the amount to be sacrificed on replacement of the assets.

A81 Under such a policy, the entity, upon receipt of the contribution, normally would recognise liabilities in excess of the contributed assets and therefore recognise a reduction in net assets. Such accounting would not only broaden the notion of liabilities to an unacceptable extent; it would also seem incongruous with the fact that the entity's capacity to achieve its service delivery objectives would have increased as a result of the contribution.

A82 The view adopted in this Statement is consistent with the views expressed in the only overseas Concepts Statement that deals specifically with restricted contributions, that is, the FASB's SFAC 6 (refer to paragraphs 56 to 58). The FASB's Statement of Financial Accounting Standards No. 116 "Accounting for Contributions Received and Contributions Made" (SFAS 116) applies the concepts set out in SFAC 6 (SFAS 116, paragraph 67).

Recognition of contributions as revenues: is there an "earnings process"?

A83 Some commentators disagreed with the recognition of contributions as revenues when control is obtained over the assets comprising the contribution. They argued that all revenues of an entity, whether the entity is profit-seeking or not-for-profit, should be recognised when they are "earned". A number of those commentators argued that meeting contributor-imposed conditions constitutes the process of earning restricted contributions. Accordingly, they argued that restricted contributions should be recognised as revenues when the conditions are satisfied, and that unrestricted contributions should be recognised as revenues when control is obtained over them. However, where contributions are received on the condition that they are to be expended on the acquisition of long-lived assets or on the discharge of liabilities, recognition of the contributions as revenues when the conditions are satisfied would appear not to reflect the "earning" of the contributions. Contributions, whether restricted or unrestricted, would appear to be "earned" as goods and services are provided to beneficiaries. Under this approach, where contributions are used to acquire depreciable assets, it would be more appropriate to recognise the contributions as revenues when depreciation of the assets is charged to expense.

A84 However, recognition of contributions as revenues when expenses are incurred in the provision of goods and services also gives rise to problems. Where contributions are provided for the discharge of liabilities, or where they are provided without conditions, a clear nexus between the contribution and the provision of goods and services would not exist. Allocation of the contributions to the provision of goods and services would be purely arbitrary. Where a contribution is provided on the condition that it be expended on the acquisition of a non-depreciable asset, such as a park or land under infrastructure, this approach would result in recognition of a perpetual liability. In addition, the decision of an entity to dispose of a grant-funded depreciable asset would accelerate the recognition of revenues vis-a-vis the retention and subsequent depreciation of the asset. The effect of this discretion detracts from the comparability of revenue recognition between entities and provides managements with a means of tailoring reported results. Furthermore, if the entity is provided with "seed money", as that term is described in paragraph A80 above, it is problematic whether revenues would be recognised as the initial outlay is depreciated, or whether the "liability for unearned grant revenues" would be maintained indefinitely. This is because it could be argued that the recipient's "performance" in respect of the use of the grant is the continued delivery of specified services.

A85 A more pervasive problem with this "earnings-based" approach to the recognition of contributions is that in a range of circumstances, it is problematic whether contributions such as grants and appropriations are paid in cognisance of past performance or future performance. For example, a grant may have been provided to restore an entity's capacity to provide services (after its erosion through depreciation), with conditions that the grant be expended on particular assets so as to provide assurance to the grantor that the service-delivery capacity would be restored. In these situations, it can be argued that the entity's performance in delivering services and incurring expenses, to which the grant relates, has occurred in reporting periods prior to the inflow of the grant. If this were the case, matching of the grant revenue against the entity's performance in providing goods and services would not be possible.

A86 These concerns with "earnings-based" approaches are not intended to imply rejection of the general proposition that contributions are frequently provided in respect of expected future performance by the recipient – rather, it reflects a view that reliable and consistent matching of the revenues with that performance is not likely to be achievable. In addition, adoption of "earnings-based approaches" would entail the recognition of "unearned" contributions as liabilities, which, for the reasons discussed above, would involve adoption of an unacceptably broad concept of liabilities.

A87 Some commentators on the superseded Statement expressed concerns that recognition of contributions as revenues when control is obtained over them, consistent with the Statement, would result in undue volatility in reported results, because the expenses which arise in satisfying any conditions attaching to the contributions frequently are recognised (in part or in full) in a different reporting period. However, not-for-profit entities are substantially dependent on contributions to fund their operations, and they cannot influence the amount and timing of those inflows in the way that profit-seeking entities obtain inflows through reciprocal transfers (such as sales) as part of their earning activities. The Boards have adopted the view that the definition of liabilities should not be broadened to encompass "unearned" contributions merely to overcome concerns of preparers that users may interpret the "bottom line" results of not-for-profit entities as if those entities can influence their period by period results in the manner of a profit-seeking entity.

A88 The notion of matching contributions revenues with expenses has been dismissed by the FASB in both SFAC 6 (paragraph 150) and in SFAS 116 (paragraph 67).

Should contributions be recognised as contributions by owners?

A89 In applying this Statement, contributions received by public sector entities would be classified as equity where they are in the nature of contributions by owners; otherwise they would be classified as revenues. It would only be in rare instances that contributions to not-for-profit entities would be in the nature of contributions by owners. This contrasts with profit-seeking entities in the private and public sectors, where some contributions are provided with the expectation of receiving a desired rate of return, and the contributor possesses rights relating to distributions of future economic benefits by the entity. In such cases, the contributions would be identified as equity.

Increased operating capability

A90 Some commentators on the superseded Statement argued that where contributions are made to a not-for-profit entity without an expectation of financial return but with the intention of "permanently" increasing the capacity of the recipient to provide services, those contributions should be classified as equity contributions and other contributions should be classified as revenues. This argument was largely based on views that:

(a) because not-for-profit entities generally are concerned with maintaining their capacity to provide goods and services to beneficiaries, rather than generating a financial return on contributions received, a physical concept of contributions by owners should be adopted; and

(b) recognition of the contributions as revenues is inappropriate because they are not "earned" during the reporting period in which the contribution is received. This issue is addressed in paragraphs A83 to A88.

A91 Implicit in this argument is the view that contributions which finance the acquisition of future economic benefits "bundled up" in infrastructure assets are different in concept from contributions which finance the acquisition of future economic benefits "bundled up" in short-lived assets. That view is inconsistent with the focus of this Statement on the essence of the elements reported rather than on their particular features – in the case of assets, the focus is on future economic benefits, however those benefits are "bundled up". All contributions "permanently" increase the net assets of the recipient compared with its net assets without the contribution. Whether the recipient retains that increase in operating capability will depend on how it uses those funds and the policies it adopts in recovering the cost of operations (including depreciation of contribution-funded non-current assets). These aspects are not inherent in the contribution. Accordingly, if so-called "capital contributions" were to be classified as "contributions by owners", all contributions would need to be classified as such.

A92 Irrespective of this concern, there are practical difficulties in identifying what was intended to be the increase in operating capability resulting from the contribution. For example, if contributions are provided to an entity on the condition that it expends them on non-current assets, how does one determine whether, and the extent to which, those funds were provided to restore a loss of operating capability due to previous depreciation (that is, enable a similar rate of output but over a longer period) or to increase the entity's rate of service delivery? This difficulty is noted in FASB Statement of Financial Accounting Standards No. 33 "Financial Reporting and Changing Prices" (paragraph 131). Expressed another way: what is the economic substance of the "difference" between a contribution to enable an entity to acquire new equipment and a contribution to enable an entity to pay the wages of employees who repair existing equipment?

A93 If the establishment of a financial interest in the net assets of the recipient and a right to a financial return were not to be retained in this Statement as essential characteristics of contributions by owners, all contributions (including, for example, periodic contributions received by clubs and professional associations from their members, and grants and appropriations received by not-for-profit entities in the public sector) would be identified as equity contributions. Not only would the meaning of contributed equity be less clear, but not-for-profit entities would report recurring deficits for the change in net assets resulting from operations – that is, non-recovery of part of the cost of goods and services provided – with a consequential loss of usefulness of the operating statement.

Role of disclosure

A94 In adopting the policies reflected in this Statement in respect of the treatment of contributions, the Boards are of the view that information about restrictions over contributions is more appropriately conveyed by disclosure of restrictions over assets than by broadening the concepts of liabilities and contributions by owners. In addition, separate disclosure of the nature and amount of contributions recognised as revenues, together with structuring the operating statement to report results of not-for-profit entities before and after contributions, is a more appropriate way to assist users to place in context revenues reported in respect of contributions. This approach is reflected in Australian Accounting Standards AAS 27 "Financial Reporting by Local Governments" and AAS 29 "Financial Reporting by Government Departments".

TABLE - International Comparison: Conceptual Framework Definitions

Australia: SAC 4	IASC Framework & South Africa: Section AC 000	United States: SFAC No. 6	United Kingdom Draft Framework: Chapter 3	New Zealand Statement	Canada: Se
ASSETS					
Assets are future economic benefits controlled by the entity as a result of past transactions or other past events. (para. 14)	An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. (para. 49(a))	Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. (para. 25)	Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. (para. 7)	Assets are service potential or future economic benefits controlled by the entity as a result of past transactions or other past events. (para. 7.7)	Assets are as a result which futu (para. 29)
LIABILITIES					
Liabilities are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. (para. 48)	A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. (para. 49(b))	Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. (para. 35)	Liabilities are an entity's obligation to transfer economic benefits as a result of past transactions or events. (para. 24)	Liabilities are the future sacrifices of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. (para. 7.10)	Liabilities a transactions result in th services or future. (para
EQUITY					
Equity is the residual interest in the assets of the entity after deduction of its liabilities. (para. 78)	Equity is the residual interest in the assets of the enterprise after deducting all its liabilities. (para. 49(c))	Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities. (para. 49)	Equity is the ownership interest in the entity: it is the residual amount found by deducting all liabilities of the entity from all of the entity's assets. (para. 44)	Equity is the residual interest in the assets of the entity after deduction of its liabilities. (para. 7.15)	Equity is the oriented ent equity of a residual, it example, ty and retained In the case sometimes r residual int liabilities. N items that m their use. (p

Australia	IASC & South Africa	United States	United Kingdom	New Zealand	Canada
REVENUES					
Revenues are inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the reporting period. (para. 111)	Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. (para. 70(a))	Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations. (para. 78)	Gains are increases in equity, other than those relating to contributions from owners. (para. 52)	Revenues are inflows or other enhancements, or savings in outflows, of service potential or future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the reporting period. (para. 7.19)	Revenues by way reductions activities arise from or the use interest, r profit org their reve other cont
		Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues or investments by owners. (para. 82)			Gains are or inciden and fror circumsta result fror (para. 39)

Australia	IASC & South Africa	United States	United Kingdom	New Zealand	Canada
EXPENSES					
Expenses are consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the reporting period. (para. 117)	Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. (para. 70(b))	Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations. (para. 80)	Losses are decreases in equity, other than those relating to distributions to owners. (para. 52)	Expenses are consumptions or losses of service potential or future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the reporting period. (para. 7.22)	Expenses by way incurrence ordinary activities.
		Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses or distributions to owners. (para. 83)			Losses a peripheral affecting events an those tha equity/net

TABLE - International Comparison: Conceptual Framework Recognition Crite

Australia: New Zealand SAC 4 & Statement	IASC Framework & South Africa: Section AC 000	United States: SFAC No. 5	United Kingdom Draft Framework: Chapter 4
An item that meets the definition of an element should be recognised when and only when:	An item that meets the definition of an element should be recognised if:	An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold. Those criteria are:	An item should be recognised in financial statements if:
		Definitions – The item meets the definition[2] of an element of financial statements;	(a) the item meets the definition of an element of financial statements;
(a) it is probable that the future economic benefits or future sacrifice of those benefits will eventuate, or that a change in those benefits has occurred; and	(a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and		(b) there is sufficient evidence that the change in assets or liabilities inherent in the item has occurred (including, where appropriate, evidence that a future inflow or outflow of benefit will occur); and
(b) the item can be measured reliably.	(b) the item has a cost or value that can be measured with reliability. (para. 83)	Measurability – It has a relevant attribute measurable with sufficient reliability;	(c) the item can be measured at a monetary amount with sufficient reliability. (para. 4)
		Relevance – The information about it is capable of making a difference in user decisions; and	
		Reliability – The information is representationally faithful, verifiable, and neutral. (para. 63)	

1 SAC 4 and the New Zealand Statement of Concepts do not specify general criteria for recognition of the elements of financial statements. The general criteria set recognition criteria specified in those Statements in respect of each element other than equity. Those particular recognition criteria are virtually identical in respect of bot

2 The definitions of assets and liabilities in SFAC 6 incorporate the concept of *probable* future economic benefits and *probable* future sacrifices of economic benefi implicit in the definitions of the other elements in SFAC 6, because those elements are defined in terms of changes in assets and liabilities.

DISSENTING VIEW

The Australian Accounting Standards Board (AASB) and the Public Sector Accounting Standards Board (PSASB) approved the revised Statement for issue in March 1995. Mr Lonergan, a member of the AASB, wishes to express a dissenting view.

Dissenting View

Mr Lonergan dissented from the revised SAC 4 (hereinafter "SAC 4"). He strongly supports the work of the AASB and the PSASB in developing a conceptual framework, and believes that (except for the matters outlined below) SAC 4 will provide useful guidance to the Boards and other interested parties in analysing financial reporting issues. However, Mr Lonergan was unable to vote in favour of the issue of SAC 4, because he believes that:

(a) the definitions of liabilities and revenues require significant amendment;

(b) application of the definitions of liabilities and revenues would create unnecessary problems in some areas where conventional accounting practice is already well established and, for all practical purposes, soundly based; and

(c) SAC 4 should place much more emphasis on the "matching principle".

Definition of Liabilities

Mr Lonergan believes that the definition of "liability" in the Framework for the Preparation and Presentation of Financial Statements, issued by the International Accounting Standards Committee (IASC), is superior to the definition of "liabilities" in SAC 4. The IASC definition is:

> "A 'liability' is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits."

Mr Lonergan is of the view that while the IASC definition is not perfect, its adoption would avoid the following flaws which he argues are contained in the definition of liabilities in SAC 4:

(i) The inclusion and position of the phrase "to other entities" in the definition of liabilities in SAC 4 makes that definition, in his view, too restrictive. Mr Lonergan notes that the definition of liabilities requires that the entity is *presently obliged* to make future sacrifices of economic benefits *to other entities* (emphasis added). He argues that the SAC 4 definition excludes items that traditionally have been, and should continue to be, recognised as liabilities. He is concerned that, for example, a statute may impose upon the entity a legally enforceable obligation which nevertheless does not satisfy the SAC 4 definition of liabilities. Similarly, he notes that paragraph 60 indicates that the intention by an entity to undertake work in the future does not of itself give rise to a liability because there is no present obligation to an external party. Therefore, he argues, the SAC 4 definition of liabilities means that provisions for future costs and the like would be treated as giving rise neither to liabilities nor expenses until related expenditures are incurred.

Mr Lonergan argues that there is a subtle, but significant, difference between a present obligation to make a future sacrifice of economic benefits to other entities (the obligation included in the SAC 4 definition) and a present obligation to other entities to make a future sacrifice of economic benefits (his preferred notion of an obligation). That is, he argues, an entity can have an obligation to other entities (for example, due to regulatory requirements such as environmental laws) to make a future sacrifice of economic benefits without being obliged to make that sacrifice to those entities. For example, an entity may undertake an environmental clean up itself. He argues that in these circumstances, the entity should recognise that obligation as a liability, but believes that the SAC 4 definition would preclude such recognition.

(ii) In his view, the position of the word "future" in the definition of liabilities appears to be wrong. Mr Lonergan is of the view that a liability should not be a "future sacrifice of economic benefits", but rather, a "sacrifice of future economic benefits". He argues that such an amendment to the definition would make it symmetrical with the definition of assets.

Mr Lonergan also believes that the definition of "liability" in the IASC Framework contains a flaw in common with the definition of liabilities in SAC 4. He believes that the distinction made between "present obligations" and "future commitments" both in SAC 4 and the IASC Framework is artificial and difficult to justify on theoretical grounds. He notes that the Statements explain the meaning of "obligations" to extend beyond legally enforceable obligations to include obligations arising from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. He believes that such an extension of the meaning of "obligations" automatically includes future commitments in the meaning of that term.

Mr Lonergan notes that amending the definition of liabilities to address his concerns outlined above may mean that the definition would be interpreted to permit some provisions which are really profit-smoothing charges to be identified as liabilities. He believes that this problem could be overcome by issuing a specific Accounting Standard on provisions and by including appropriate commentary in SAC 4 that such provisions should not be treated as liabilities. He also believes that this problem could be substantially overcome if greater emphasis were to be placed on the "matching principle". Mr Lonergan's views on the "matching principle" are outlined in the last section of this dissenting view.

Definition of Revenues

Mr Lonergan is of the view that the definition of revenues in Statement of Financial Accounting Concepts No. 6 "Elements of Financial Statements" (SFAC 6), issued by the Financial Accounting Standards Board (FASB), should be adopted in SAC 4. That definition is:

> "Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations."

Mr Lonergan believes that there are two fundamental problems with the definition of revenues in SAC 4, which would be overcome by adopting the SFAC 6 definition. These are set out below. Consistent with the approach adopted in SFAC 6, he supports the defining of revenues and expenses as separate elements from "gains" and "losses".

(i) *"Increase in equity"*

Mr Lonergan believes that the definition of revenues in SAC 4 does not help explain why a cash sale of inventory at its book value gives rise to an item of revenue and *yet* a cash settlement by a debtor of the full amount of a debt does not give rise to an item of revenue. He believes that if the words "that result in an increase in equity" are intended to cover this distinction, they are inadequate. He believes that the requirement that an increase in equity must occur for an item to satisfy the definition of revenues should be deleted on the grounds that potentially it is too restrictive. For example, the sale of inventories or factoring of receivables for a consideration exactly equal to their current book value may not give rise to an "increase in equity during the reporting period". Mr Lonergan believes that on this basis, many items that should be treated as revenues, and which under conventional accounting are treated as revenues, may be interpreted as falling outside the definition of revenues in SAC 4.

(ii) *Reference to normal operating or trading activities*

Mr Lonergan is of the view that the definition of revenues should provide a reasonable basis for distinguishing inflows arising from trading activities from inflows arising from non-trading activities. He believes that this distinction is fundamental to conventional performance assessment techniques, such as relating various "operating costs" to various "inflows from trading activities". Mr Lonergan believes that acceptance of these performance assessment techniques explains why some items reported as revenues are "gross inflows" while others are "inflows net of related costs". He argues that it would be inappropriate to relate "operating costs" to revenues as defined in SAC 4, which could include proceeds arising from "non-trading" activities (for example, the sale of a building).

Mr Lonergan believes that to report the performance of the entity, revenues, expenses, gains and losses should be reported separately in the profit and loss or other operating statement. He believes that the definitions of the elements should reflect this distinction, rather than for the matter to be addressed at the display level of the conceptual framework, because defining revenues and expenses to include items that may be regarded as "gains" and "losses" may encourage the display of revenues and expenses without being structured in a way that assists performance assessment.

Mr Lonergan notes the view enunciated in paragraph A15 of the "Background and Basis for Conclusions" that the SFAC 6 definition of revenues involves arbitrariness in defining ordinary operations. He notes that this arbitrariness may lead to inconsistency of treatment in marginal cases. However, he believes that this does not appear to have been a major practical problem in the United States of America, and nor has the separate reporting of revenues and gains been a major practical problem to date in Australia, and that this limitation is preferable to the defining of revenues in SAC 4 to include gains.

Matching Principle

Mr Lonergan is of the view that SAC 4 places inadequate emphasis on the matching principle and relegates what he believes to be a fundamental accounting concept to a status no greater than being supported provided it does not conflict with the definitions and recognition criteria for the elements of financial statements. He believes that this differs from conventional practice and conventional interpretation of financial reports.

Mr Lonergan believes that SAC 4 should give more explicit recognition to the matching principle. He argues that while, in some circumstances, there is a fine distinction between "matching" and "income smoothing", the framework needs to define matching in the context of accrual accounting, which is generally accepted. He believes this is necessary if the concepts are to clarify that the financial effects of transactions and other events should be recognised in the reporting periods to which they relate, regardless of whether cash is received or paid.

Mr Lonergan argues that greater emphasis on the matching principle would avoid many of the problems (outlined above) which he believes can arise if the definition of liabilities in SAC 4 is applied. For example, he believes that explicit recognition of the matching principle would support the identification of liabilities under the matching principle in those circumstances where a present obligation to other entities does not exist. He believes it would also help avoid situations which could otherwise arise where an item meets the definition and criteria for the recognition of assets in SAC 4 but the corresponding (and, for all commercial purposes, matching) obligation fails (however narrowly) to meet the definition of liabilities in SAC 4.