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"Soft" Points of International Financial Reporting Standards

Introduction

International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) have been working together since 2002 to achieve convergence of International Financial reporting Standards (IFRS) promulgated by IASB and US Generally Accepted Accounting Principles (GAAP) promulgated by FASB. Among other things a joint project updating and refining existing concepts of common conceptual framework of financial statements was started 2006. First half of this project's eight phases are currently active, among them phase B "Definitions of elements, recognition and derecognition". Thus there is a suitable time point to discuss about the basic elements and concepts of these norms, although one of the eight phases mentioned above is already completed. This effort may also offer some points of view to a reader who is interested in analytical thinking in developing international accounting norms and in their applications.

Even if this essay includes critique of IFRS I find it necessary to point out that in the present world with all its globalization effects and implications, an international code for communication of financial information of business activities is necessary, indeed. Because of cultural and language barriers between countries and nations such a communication would be all too complicated without a common code.

It has to be remembered that IASB (originally International Accounting Standards Committee) was established as recently as 1973, less than 40 years ago. Creating tens of standards takes time and effort, and adjusting standards according to the received feedback maybe even more. Simultaneously new business and financial phenomena appear the information of which is considered necessary to be included in financial statements (e.g. numerous new financial instruments developed during recent years).

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IASB promulgates that it is "committed to developing, in the public interest, a single set of high quality, global accounting standards that require transparent and comparable information in general purpose financial statements." Official pronouncements with an effective date on 1 January 2011 or earlier considered of 8 IFRSs, 29 IASs, 17 IFRICs (interpretations of International Financial Reporting Interpretations Committee) and 11 SICs (interpretations of Standing Interpretations Committee) presented on about 2900 printed pages. The latest pronouncement at the time being is IFRS 13 Fair Value Measurement approved by IASB in May 2011.

It has to be admitted that developing of a code like IFRS is no way an easy task. In the very first beginning it has to be solved which one, if any, of known accounting theories to choose as a basis of the standards. It is obvious that the code can hardly ever lean rigidly on one theoretical approach of accounting only. To be plausible a code has to have, however, a logical structure of orders, prohibitions and allowances. They must not be in a mutual contradiction. Like in legislation, the various concepts used in standards should be clearly and logically enough defined.

A very important limitation of IFRS is expressed in paragraph 9 of Preface to IFRSs: "IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities." This excludes the financial statements of all non-profit entities and of other similar organizations.

Framework for the Preparation and Presentation of Financial Statements

A Framework for the Preparation and Presentation of Financial Statements (the Framework) precedes the standards. It "sets out the concepts that underlie the preparation and presentation of financial statements for external users". In its section "Purpose and Status" after a long list of purposes of the Framework, it is stated, however, that "nothing in this *Framework* overrides any specific International Accounting Standard." Consequently in a case of a conflict "the requirements of the International Accounting Standard prevail over those of the *Framework*". IASB expects that cases of conflict will diminish, even if not disappear totally in the long run.

The statement above means that the IFRSs are sort of a collection of norms which may be contradictory with each other. It is shown later in this essay that this holds for even some essential norms. It is no wonder that IFRSs have to be supported by many interpretations (SICs and IFRICs).

Many of the definitions of basic concepts in the Framework are rather vague, some even indefinite. What else can be said e.g. about the definition of expenses: "The definition of expenses encompasses losses as well as those expenses that arise in the course of ordinary activities of the entity."[1] What follows is listing some examples of expenses, and a comment: "They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment." Loss is defined to represent "decrease in economic benefits". Despite of different wording, loss is defined as a matter of fact in no different way than expense. Consequently, losses are not regarded a separate element.

The construction of the definition of income is similar vis-à-vis the definition of expense, and equally vague. Income is said to

1 Framework, para. 78.

cover both revenue and gains. Vaguely defined concepts cannot lead to a very logical set of norms. In addition, the concept of revenue is presented in IAS 18, and the concept of contract revenue in IAS 11. Some find these definitions as well as presentation of revenue recognition confusing.[2]

Another example of a vagueness of the Framework is the definition of accrual basis: "Under this basis, the effects of transactions and other events are recognized when they occur (and not as cash or cash equivalent is received or paid) and they are recorded in the accounting records …"[3] This applies, no doubt, to recording income and expense or cost: The time point of receiving of a production factor or of the delivery of a product is the basis for recording on accrual basis. The time point of cash or cash equivalent transaction due to an expense or income is a secondary basis which may or may not coincide with the purchase or delivery time point. But there is a category of transactions for which the time point of payment (as cash or cash equivalent is received or paid) is the primary basis for recording: finance transactions. They are all transactions except expenses and income, e.g. paying a payable or raising a loan. The Framework does not know the concept of finance transaction. This may be due to the fact that IFRSs do not include any norms for recording transactions but only their recognition in the financial statements.

Fair value

The concept of fair value is very central in IFRS. In about half of IFRSs/IASs and their interpretations fair value is used or referred to. IASB has recently published a new standard IFRS 13 Fair Value Measurement, to be applied for annual periods beginning on or after 1 January 2013, although earlier applications are permitted. In this over 50 pages long standard various methods to measure fair value are discussed and presented. It causes amendments to 30 standards or their interpretations.

IFRS 13, para. 9 defines "fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". An application of measuring fair value of a non-financial asset is presented in para. 27. There the concept of selling or purchasing price is replaced with "highest and best use" as a primary valuation basis.

Fair values except those that are determined by stock or commodity exchanges or alike are always more or less depending on the subjective expectations of the preparer of financial statements. This applies, no doubt, especially to the valuation on the basis of the highest and best use of a non-financial asset. For most of the non-financial long-term assets it is not possible to find any market participant to apply this valuation approach.

It has to be remembered that preparing financial statements always demands that the expectations of future are considered. In this context the concept of measuring means estimating or determining action in the first place.[4] The content or nature of measuring for value of something that is expected to occur first in the future differs from the content or nature of the

2 The nature of the definitions of revenue and expense in the Statement of Financial Accounting Concepts No. 6 of FASB is comprehensive.

3 The Framework, para. 22.

4 Replacing words "estimating" and "determine" by "measuring" of fair value e.g. in IAS 16, para 26, raises some confusion at least among readers outside the area where English is the mother language.

conventional concept of measuring.

Future expectation is the basic element especially in deciding which part of the purchase cost of a non-financial asset to include as expense in the profit and loss statement and which part to "save" as a non-financial asset in the balance sheet to be included as depreciation expenses in the later profit and loss statements. The subjectivity in this decision concerns, however, only the allocation of the purchase cost over the period of asset's use. The additional subjective element of almost any fair value measurement except that based on public exchange prices does not help the solution of defining the impact of future events on the financial statements. Only a public exchange price or an equivalent basis can be considered neutral enough to limit, if not totally to exclude, the impact of subjective element in valuation.

Some inconsistencies of individual standards

IAS 16 (Property, Plant and Equipment)

It is worth noticing that the concept of cost is not defined in Framework but in IAS 16: "Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognized in accordance with the specific requirements of other IFRSs, e.g. IFRS 2 Share-based Payment."[5]

It is not easy to understand why cost is defined and presented in an individual standard instead of the Framework. The concept of cost is, however, included into the examples of expenses in the Framework, one of which is "cost of sales". Logically seen every purchase of production factors causes cost. It is unnecessary to limit the concept of cost to the purchase of property, plant and equipment only. Some cost are expensed in the profit and loss statements in the next profit and loss statement, some may be allocated to more than one financial period e.g. in the form of depreciation (or loss when no more income is to be expected on the basis of certain cost). In the end of the day both expense and cost are "amount of cash or cash equivalents paid" for the purchase of production factors. This leads easily to an idea that cost and expense basically mean the same thing. Cost means purchase price (or fair value) of any type of production factor while expense means the share of a cost that is recognized in profit and loss statement, e.g. in the item called depreciation or cost of sales.

According to IAS 16, para 15 "an item of property, plant and equipment … shall be measured at its cost". An entity shall choose either the cost model (where an asset shall be carried at its cost less accumulated depreciation and any impairment losses) or the revaluation model (where an asset shall be carried at a revalued amount similarly to cost model). It is worth of noticing that in para. 36 it is required that either one of these models shall be applied to the entire class of property, plant and equipment to which the asset belongs. In para. 37 totally eight classes of property, plant and equipment (ships, aircraft, motor vehicles etc.) are listed as examples. It follows that in a balance sheet (statement of financial position) it is possible that the item "property, plant and equipment" include assets based on cost model as well as based on

5 IAS 16, para. 6. The definition is repeated in IAS 38. In addition of expense and cost the concept of expenditure is used e.g. in IAS 38, para. 68, where it is ruled when an expenditure shall be recognized as an expense.

revaluation model. It could be said that this situation is not very well suited to the clarity of financial information.

IAS 38 (Intangible Assets) vs. IAS 36 (Impairment of Assets)

According to IFRS 3 (Business Combinations) goodwill is "an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually defined and separately recognized". According to BC328 of IFRS 3 "goodwill is measured as a residual". This is based on para 10 of IFRS 3, according to which "the acquirer shall recognize, separately from goodwill, the identifiable assets acquired". This may "result in recognizing some assets … that acquiree had not previously recognized as assets … such as brand name, a patent or customer relationship…" (para.13).To express it simply: goodwill is the difference between the purchase price of a business and the net assets at their acquisition-date fair values.

Assets like brand name or patent as well as customer relationships are typical intangible assets. According to IAS 38 intangible assets may have either indefinite or definite useful lives. Patents represent intangible assets with definite useful lives. Intangible assets with indefinite lives shall not be amortized (para. 107). Instead, they shall be tested for impairment very much similarly as goodwill is tested according to para. 88 of IAS 36.

The proscription of amortization of indefinite intangible assets to which also goodwill belongs is not logical if the unanimous rule of para. 48 of IAS 38 is taken into consideration: "Internally generated goodwill shall not be recognized as an asset." Keeping the recognizable value of an intangible asset like brand demands business activities that cause expenses. Imagine acquiring a brand (or trademark) like Coca-Cola. To keep up the brand requires e.g. advertising and sales promotion activities. Mere sitting by the phone and waiting for orders would no doubt lead to a shrinking volume and market share. The value of Coca-Cola brand would decline rapidly. It is only natural that advertising and other marketing activities would be continued after the acquiring. Due to these activities the brand of Coca-Cola can be kept on its original level. It is not due to the purchased brand the value of which should consequently be amortized.

The same holds for goodwill, too. But all those expenses due to business activities to keep goodwill's value up on the acquired level means recognizing internally generated goodwill as an asset. At the same time the necessary amortization of goodwill is neglected.[6]

IFRS 2 (Share-based Payments)

One reason to the paradoxical presentation of the definitions of cost and expense may be IFRS 2. It is stated in para 10 of IFRS 2: "If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted." In the following paragraph it is said that this rule concerns especially "transactions with *employees and others providing similar services*".

This rule turns the concept of expense upside down. It fits in none of the measurement rules of paras. 99–102 in the Framework: historical cost, current cost, realizable (settlement) value or present value.

6 This may due to the lack of matching principle among the underlying assumptions of the Framework.

In the end of the day, share based payments represent non-cash contributions to share capital. The basic idea of such a contribution is that it is an asset eligible to increase the total assets of the firm at the moment of the release of shares.[7] The services of the personnel can be assimilated with the services of outsiders. The basic principle of full compensation for the shares issued (or transferred) applies to both cases. That's why it is not logical to evaluate the compensation "indirectly" on the basis of the issued (or transferred) shares only. The receiver of the shares acquires a larger share of the rights to the assets of the company. Releasing shares against services that are not eligible as assets is not an expense according to the Framework, nor a cost according to IAS 16. Instead it means dilution of share owning from the viewpoint of other share owners.

It is not possible to apply IFRS 2 in preparing the financial statements of an individual entity e.g. in Finland. The Finnish Company Act denies releasing shares against services. An application is possible on the level of group statements only.

Conclusion

I do not expect that an essay like this would have any influence what so ever on the joint projects of IASB and FASB described above. Analyzing critically IFRS is, however, an interesting intellectual exercise, the temptation of which I have not been able to resist.

This essay is not aiming to a detailed criticism of IFRS. Only a few "soft" points have been covered to show the need of clarifying its norms, first of all the basic concepts, and their mutual relationships. According to my opinion the softest point of IFRSs is its Framework due to the fact that any specific norm in the standards overrides the norms of the Framework.[8] The core of financial information of an entity is based on the financial statements which in turn are based on the double-entry bookkeeping. IFRSs are not dealing with the recording process of financial transactions. It appears to me that a clear concept of recording process would assist in reaching logical construction of norms for financial statements. Perhaps it has been tried to express too many characteristics of the production process of a firm under the IFRS concept of financial statements.

What comes to the individual standards the softest points of specific standards are according to my opinion impairment tests and applying fair value. Both tasks are to a great extent left with subjective evaluations of the preparers of the financial statements. As a matter of fact, fair value is different for different decision makers. Including fair values into the financial statements also creates often uncertainty due to its increasing effect on the variation of profit and loss. In addition, adapting fair values is against generally known realization principle, which is, however, not included in the Framework.

Yuji Ijiri once wrote that "payment is a fact, financial statement a forecast". The basic element in preparing financial statements is the assumption of "going concern". Independent of the theory, method or principles the preparer of financial statements has applied, considering the expectations of the future is necessary. This

7 Remember the definition of assets in para. 53 of the Framework: "The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity." (underline by VR)

8 The Framework is, however, not an International Accounting Standard as explicitly stated in the Framework.

consideration is the “soft” point ever present in preparing financial statements.

On the other hand basing the preparing financial statements on some consistent accounting approach may lead to an easier preparing and a clearer presentation. That is, no doubt, to enhance understanding the information produced by financial statements. The first requirement would be writing the Framework in such a form that it could be followed in every single standard.

There is still one more point worth of mentioning. The adaption and promulgation of IFRSs has lead, at least in Finland, to a almost total lack of interest in research of normative accounting theory, and not necessary to say, to a lack of interest in any theoretical contemplation of accounting. This is in a clear contrast to the previous development in Finland. The national accounting law used to be based to a dynamic accounting theory developed domestically but leaning on generally known accounting principles. Although the theory is not covering all new contemporary characteristics of e.g. capital markets in detail, the law worked and is still mainly very well working from the point of view of small and medium-sized enterprises.

One sign of the power of the theory described above is that it is still applied in valid Finnish business taxation law. Its strength lies in clear and logical definition of the financial accounting process as well as in its clear and logical basic concepts like cost, expense, income, and finance transaction. Did this situation cause inertia in adopting IFRSs or did it contribute to better understanding of them in Finland? For me this is a question still waiting for an answer. ■