

CONTROVERSY REGARDING ELEMENTS IN THE FINANCIAL STATEMENTS

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ABSTRACT:

The definitions of the elements identify their main traits, but their purpose, the reason for their presence in the financial statements is ensured by meeting the recognition criteria.

The current concerns of accounting regulatory organisms in setting and developing the elements and the common conceptual Framework have materialized by setting recognition criteria, that help to achieve a more accurate position of elements in the financial statements, thus creating credibility and relevance of the information contained within it.

This study follows, by comparison, recognition criteria of elements presented in financial statements in various accounting referential meaning.

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IASB Conceptual framework – defines recognition as the process of incorporating in the balance sheet or profit and loss account a first element that satisfies the definition and fulfills the following finding criteria:

- it is likely that any future economic advantage will enter in/out the entity;
- element has a cost or a value measured reliably².

We notice that the requirement for profitability of economic advantages comes to highlight the elements definitions that circumscribe to the existence of these benefits.

The first criteria set by the IASB general conceptual Framework is the *probability concept*. It is used in correlation with the degree of uncertainty that the future economic benefits associated with the item will affect the benefit or loss of the entity.

Evaluating the uncertainty related to future economic benefits refer to the information available at the time of the financial statements.

The same IASB conceptual Framework specifies that an item that has all the essential characteristics but does not satisfy the recognition criteria can generate a briefing in the Annex of financial statements.

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² International Standard of Financial Reporting (IFRS) – Oficial regulations issued at January The First of, CECCAR, Bucharest, 2011

Such a briefing becomes relevant when knowing these items is considered useful for evaluating the financial position of performances and the evolution of financial position by the users of financial statements.

At the same time, recognition criteria involve interdependence between elements, meaning an item that meets the definition and criteria for finding (for example an asset) to automatically assume finding another element (for example income or debt).

Also, the IASB conceptual Framework states that an item that does not satisfy at a certain point the recognition criteria can later satisfy them as ulterior events.

The American conceptual Framework pays a great importance to the recognition of the items in the financial statements, using a distinct structure of the Framework, SFAC 5 *Recognition and Measurement in the Financial Statement of Business Enterprises* that defines recognition as incorporating an item in the financial statements when certain criteria recognition are met, having a descriptive and numeric form, just like IASB Framework³.

According to IASB conceptual Framework we have to highlight that although compliance with the items definition is not a recognition criterion, like the American Framework, it still has to be a priority in recognizing an item in the Balance sheet or the Gain and Loss account.

It also should be noted that the criteria for recognition of an item in the financial statements proposed by FASB are more detailed than those required by the IASB framework, but must be applied in the context of the limitations of cost-benefit relationship of the materiality threshold.

These recognition criteria specify:

- definitions - an item to be recognized in the financial statements must first meet the definitions required by SFAC 6 Elements of Financial Statements;
- evaluation (measuring) – information corresponding to the item must be useful for the users in making decision;
- credibility (reliability) – the item information must be faithful, neutral and verifiable⁴.

However, SFAC 5 specifies that recognition process includes both initial recognition, subsequent amendments and derecognition (removal of the item in the financial statements), something that is not explicitly defined by international conceptual framework.

On the other hand, American conceptual framework does not define the *concept of probability* distinctly among the criteria for recognition, but it is induced by the definitions set by the framework for the items that will be recognized in the financial statements.

The second condition that an item must satisfy in order to be recognized in the financial statements which are found in both Referential, more or less detailed, is that the element

³ SFAC 5 Recognition and Measurement in Financial Statements of Business Enterprises, 2011

⁴ SFAC 5 Recognition and Measurement in Financial Statements of Business Enterprises, 2011

must have a *cost or a value which can be measured reliably*. In many cases the cost or value has to be estimated.

Using reasonable estimates is an important part in making financial statements and it doesn't affect their credibility.

If a reasonable estimate cannot be achieved then the element will not be recognized in the Balance sheet or the Gain and Loss account, but it can be presented in the explanatory notes regarding that item if it is relevant for the evaluation of financial statements, performance, or the change in the financial position.

Returning to the concept of probability used for recognition, which is accompanied by a degree of uncertainty related to future economic benefits associated with, it can be said that the assessment of the probability of generating future economic benefits coupled with uncertainty has a significant influence in the recognition and accurate positioning of an item in the financial statements.

This can be best exemplified on *provision, debts and contingent liabilities*, where the degree of probability makes the difference between these items.⁵

IAS 37 Provisions, assets and contingency debts state that uncertainty of the contingency and size of final value is the one that separates the provisions from debts.

According to IAS 37, provisions are doubtful liabilities/debts from the point of view of contingency, or the amount related, thus having a doubtful character.

Provisions are recognized in the Balance sheet if the following conditions are fulfilled:

- entity has a present obligation after a past event;
- it is probable that an outflow of resources to affect economic benefits to honour the obligation related(there are more chances to achieve it), that means that the probability of generating economic benefits in the future is high, thus we see that the recognition criterion is essential for positioning provision in the Balance sheet;
- the value of obligation can be assessed reliably. (IAS37 states that only for a few rare cases a reliable assessment cannot be made).

A *contingent debt* is a *possible obligation* following past events and its existence will be confirmed only if future events appear or not, events that are not under the influence of the entity; or a *present obligation* following past events.

Due to conditions presented above a question rises: can the contingency debt be acknowledged in the Balance sheet? Because it does not fulfil all recognition criteria: even though it is an obligation generated by past events it is unlikely that outflows of resources will be needed for it to be settled, meaning that the probability to generate future economic benefits is a lot smaller; the value of obligation cannot be evaluated reliably enough, in these circumstances there information in the explanatory notes about the existence of a

⁵ International Standards of Financial Reporting (IFRS) – Official rules issued at January First 2011, CECCAR, Bucharest, 2011

contingency debt, because the information provided shows the financial position, performance and changes in the financial position.

OMFP no. 3055/2009 regarding approving accounting regulation according to European directives defines in the same manner these elements and their criteria for recognition in the financial statements. The Order defines contingent debts in the same manner and states that they will not be recognized in Balance sheet, but only outside the Balance sheet, that is in the explanatory Notes⁶.

1. RECOGNIZING ASSETS IN THE BALANCE SHEET

IASB general framework highlights recognition criteria in relation with the nature of informational structure in the financial statements.

An **asset is recognized** in the Balance sheet when it is likely that future economic benefits are constituted in flows towards the entity and the asset has a cost or value that can be evaluated in a reliable manner. When it is not probable that inflow of cash generate economic benefits for the entity in the future then an asset is not recognized in the Balance sheet. In turn such a transaction will generate assuming an expense in the Gain and Loss account.

The economic benefits generated by assets are reflected by their capacity to contribute directly or indirectly to the inflow of cash entering the entity.

General guidance on the recognition of assets of the IASB Framework (materialized in the criteria for recognition) is completed with other details given by specific standards (IAS 38 Intangible Assets, IAS 16 Property, IAS 36 Impairment of Assets, and IAS 39 Financial Instruments: Recognition and evaluation).

Revised IAS 38 Intangible Assets detailing recognition criteria specified in the Framework for intangible assets, namely:

- probability criterion is considered to be fully satisfied for intangible assets acquired separately or in a group of entities ;
- fair value of an intangible asset acquired in a group of entities can be determined, usually with sufficient reliability for it to be recognized separately from goodwill⁷.

Under IAS 38 Intangible Assets, Intangible assets are identifiable non-monetary assets without physical substance, controlled by the entity as a result of past events and from which economic benefits are expected by the entity. The same standard states that if one of these conditions is not met, then it is recognized as an expense and not an intangible asset. However, if the item is acquired in a combination of entities, then he will be recognized as goodwill. Therefore we can say that the *recognition of an intangible asset requires the fulfillment of four criteria*: to be identifiable (for example sto separate legal rights, to identify the future economic benefits arising from the asset), control (for example legal

⁶ OMFP no. 3055/2009 regarding the approval of accounting regulations according to european directives

⁷ International Standards of Financial Reporting (IFRS) – Official rules issued at January the First 2011, CECCAR, Bucharest, 2011

rights) and generating future economic benefits. In addition to these is the general criterion of reliable evaluation.

A more difficult problem is the *recognition and measurement of intangible assets* arising from the entity. In this regard, IAS 38 Intangible Assets comes with additional details. The standard specifies that the trade marks, titles of publications, and other internally generated intangible assets are not recognized as such because they can not be distinguished from the cost of developing the business as a whole.

If purchased goodwill meets the conditions for recognition as an asset in the balance sheet, the same can be said of internally generated goodwill. This goodwill can not be measured reliably (does not meet the second criterion for recognition), and therefore will be recognized in the Gain and Loss account. Also, there are situations in which the entity is involved in *research projects* that generate expenditure. The accounting treatment of these costs will be different as they can be attached to the research phase and the development phase. Thus, IAS 38 Intangible Assets states that research and development expenditure being acquired from a group of entities and recognized separately from goodwill as an asset shall be recognized as an expense if they are related to research and development, but do not meet the recognition criteria of an intangible asset. If the criteria are met, the costs of an ongoing development project will be recognized as an intangible asset.

Under **IAS 2 Inventories**⁸, the *first condition* for recognition is that stocks lead to benefit, earnings in any form for the entity, whether by sale or by helping to obtain goods or services to be sold, either by settling of debt and the *second condition* involves determining the cost of inventories.

Residual goods can be recognized only when they can be sold, or when they can be sold and the amount which is recorded is determined based on the price recovery that is probable.

General guidance on the recognition of assets given by IASB is completed by **moments of recognition**.

Even if neither the general Framework nor IAS1 Presenting financial statements do not state the moments of recognition, these are clearly defined and developed as *specific standards* that make the frame of reference whole. Thus we can identify the following moments of recognition:

1. **Initial recognition** – representing an item in the financial statements for the first time, for which there are details in the Framework on the probability of entry of economic benefits, to their control and measurement reliability taking account of the conditions specific to entity;
2. **Ulterior recognition** – implies changing the value to an asset already recognized and presented in financial statements generated by different events. In regard to assets, they can be modernisations, replacements, depreciations, re-evaluations, for which there are specifications in: Tangible Assets IAS 16, IAS 38 Intangible

⁸ International Standards of Financial Reporting (IFRS) – Official rules issued at January the First 2011, CECCAR, Bucharest, 2011

Assets, IAS 36 Impairment of Assets, IAS 40 Investment Property IAS 39 Financial Instruments: Recognition and Measurement;

3. **Derecognition of asset** – derecognition requirements of specific standards, underlines that an asset should be removed from the financial statements when it no longer meets the definition of asset, or at least one of the criteria for recognition. Disposal of assets in the financial statements under the conditions specified above, may be based on simple cases as retirement or disposal, together with more complex cases such as assets generated by construction contracts are removed from the financial statements when it comes to the final stage of the process of construction, the costs upfront are derecognized performed when the entity realizes benefits, etc.

For example, *financial assets* from the financial instruments category circumscribed to *IAS 39 Financial Instruments: recognition and evaluation*:

1. Circumscribe to criteria that states that an entity must recognize a financial asset in Balance sheet when it becomes a part of contract of the financial instrument*. When a financial asset is initially recognized the entity must evaluate it at its cost, at its correct value, that is its fair value of the consideration offered.
2. Standard states the recognition and subsequent evaluation of all financial assets generated by any impairment. Thus, the entity shall assess at each balance sheet date whether there is objective evidence that a financial asset would be considered impaired. If there is, and the recoverable amount is less than the record an impairment loss is recognized.
3. According to the standard on derecognition, an entity shall derecognize a financial asset only when the entity loses control of the contractual rights that include the financial asset. An entity loses this control if the performing rights to benefits specified in the contract, expire, or the entity waives those rights.

The present accounting legislation, **OMFP no. 3055/2009 regarding the approval of accounting regulations according to European directives**, state the same recognition criteria for an asset as the IASB framework.

2. RECOGNIZING DEBTS IN BALANCE SHEET

According to accounting referential, **a debt is recognized in the Balance sheet** if it satisfies the requirements from definitions and recognition criteria. A transaction or other relevant event can have different effects on the entity debts, like: to create a new debt or to increase the value of an existing debt, if so it is necessary to determine the recognizable character; or to generate settling the debt or transfer it⁹.

Also, this impact may leave intact certain obligations inherent in a debt, while others are paid or transferred. In any event, it will be necessary to consider whether existing debt that has been affected should be fully or partially derecognized from the Balance sheet. In most cases, the obligation is reflected by generating transactions of goods and services received,

⁹ International Standards of Financial Reporting (IFRS) – Official rules issued at January the First 2011, CECCAR, Bucharest, 2011

which implies the existence of amounts to be paid. Thus, once transaction is recognized the certainty of the future transfer of benefits from the entity appears. There are debts that involve estimates of the value and require the entity choosing a value from a multitude of possibilities so that the criterion of credibility is fulfilled It's about provisions for risks and expenses - for which the credibility assessment is more difficult due to the uncertainty that characterizes the output of future benefits. For these kind of problems exists *IAS 37 Provisions for risks, assets and contingency debts*.

General guidelines regarding materialized debts in recognition criteria are completed by **recognition moments** as follows:

1. **Initial recognition** – follows specifications from any conceptual framework regarding the probability of economic benefits outflow to past events existence, to reliability of benefits measured, according to specific conditions of the entity ;
2. **Ulterior recognition** – from reliability point of view we can fit here debt recognition generated by changes in the exchange rate that affect recognized items following currency transactions, provisions for risks and expenses generated by the probable inflow benefits estimated and probable debts regarding postponed taxes;
3. **Derecognition of debt** – generated by its settlement or in case of provisions by risk or case creation disappearance.

General guidance on the recognition of liabilities given by IASB is supplemented with other details, and here we can mention IAS 37 Provisions, contingent assets and debts, IAS 39 Financial Instruments: Recognition and Evaluation.

IAS 37 Provisions, assets and contingency debts distinguishes¹⁰: provisions that are accounted as debts (assuming that can be reliably estimated) because they are present obligations and it is probable that an outflow of economic benefits will be required to settle the obligations and contingent liabilities that are not accounted as debts because they are either potential obligations or present obligations that do not meet the recognition criteria.

IAS 39 Financial instruments: recognition and evaluation specifies that financial debts are recognized in the Balance sheet when the entity becomes part of the contract specifications of the financial instruments.

Recognition criteria of debt in the financial statements are filled with moments of its recognition. In this regard, **the example** of financial debts *is recognized initially* at fair value of the consideration received for the purchase financial debt. There is *further recognition* of financial debts they were valued at depreciated cost (initial value less the value of repayments discounted at the interest rate and the amount of the impairment). It is noted the *time of derecognition* of financial statements when the financial debts under the contract are fulfilled, canceled or no longer applicable.

¹⁰ International Standards of Financial Reporting (IFRS) – Official rules issued at January the First 2011, CECCAR, Bucharest, 2011

The present accounting legislation, **OMFP no. 3055/2009** regarding the approval of accounting regulations according to European directives states the same recognition criteria for a debt just like IASB general framework.

3. RECOGNIZING EQUITY IN THE BALANCE SHEET

Neither **IASB or IAS 1 Financial statements presentation** do not mention any recognition criterion or other helpful information to support recognizing equity in financial statements.

Therefore Equity recognition analysis should be based on its definition, found in the IASB and IAS 1 Presentation of Financial Statements, as the owners residual interest in the assets of an entity after deducting all of its liabilities¹¹.

Basically, the definition of equity is a calculated relationship between the assets and debts of an entity.

By reference to the elements of calculation, assets and liabilities, for which the IASB established clear criteria for recognition, would mean to recognize capital only when the conditions of recognition of the two types of elements in the relationship are fulfilled.

Both the IASB and IAS 1 Presentation of Financial Statements under classify equity as Balance sheet item, exemplifying when separate elements are to be presented in equity structure: funds from shareholders, gross capitalized, which is the allocation of retained earnings reserves, reserves that are adjustments to maintain the level of capital.

Therefore recognition criteria specified by IASB can not be directly applied to the capital items above, because of the definition of equity as calculation between assets and liabilities and not through identifiers linked to the generation of economic benefits. Another important aspect related to the recognition of equity is the uncertainty accompanying the criterion of probability of entry / exit of future economic benefits from the definitions of assets or debts. The touching matter starts from the fact that equity is defined as an interdependency relation between assets and debts. As the recognition of an asset or debt from the interdependence relation may appear a certain degree of uncertainty, it is reflected on the recognition of Equity.

Equity instruments are included in financial instruments category, which *IAS 32 Financial instruments* defines as a contract that emphasizes the residual interest in entity assets after settling all its debts¹².

As with financial assets and debts, equity instruments recognized in the Balance sheet is made only when the entity becomes a party to the contractual provisions of the financial instrument.

¹¹ International Standards of Financial Reporting (IFRS) – Official rules issued at January the First 2011, CECCAR, Bucharest, 2011

¹² International Standards of Financial Reporting (IFRS) – Official rules issued at January the First 2011, CECCAR, Bucharest, 2011

If neither IASB nor IAS 1 Financial statements presentation do not give any information regarding recognizing the equity element from the Balance sheet, the same cannot be said about IAS 39 *Financial instruments: evaluation and recognition*, that provides information to this regard.

A delicate matter regarding financial instruments is the *demarcation between financial debt and equity instrument* in order to classify it in the Balance sheet. To overcome this problem, IAS 32 *Financial Instruments: Disclosure and Presentation* establishes the defining element that separates them, namely, the existence of a *contractual obligation of the issuing entity*: either to deliver cash or another financial asset to another entity (the holder of the instrument) or to exchange financial instruments with another entity (tool holder) under potentially unfavorable conditions for the issuing entity.

If there is no such contractual obligation, the instrument meets the definition of a financial debt and if does not generate such an obligation for the issuer in any of the two cases presented, then it falls into the category of equity instruments.

4. RECOGNIZING EXPENSES AND INCOME IN GAIN AND LOSS ACCOUNT

Result, as a performance evaluation is presented in **IASB** through two structure categories: expenses and income.

Definitions of income and expenses punctuate their significant features, but these must be supplemented by criteria that must be met in order to be recognized in the Gain and Loss account.

Expenditure and income recognition is not achieved independently as for assets and debts, but are generated by changes in assets or debts with direct impact on changes in equity.

The **expenses** are recognized in the Gain and Loss account when there is a decrease in future economic benefit generated by an asset or a decrease of growth in debt, and when the decrease in future economic benefits can be measured reliably¹³. This means that recognition of expenses shall be made simultaneously with the recognition of an asset decrease, or additional debt in the balance sheet.

Also, IASB accepts recognition of an expense in the Gain and Loss account when:

- a direct link between costs made and corresponding income is realised, process called connecting expenses to income;
- some economic benefit is expected referring to several accounting periods, when associating with income is done indirectly and vaguely, expenses are recognized in the Gain and Loss account based on systemic and rational allocation (appropriate use of assets that generate economic benefits over several future periods or

¹³ International Standards of Financial Reporting (IFRS) – Official rules issued at January the First 2011, CECCAR, Bucharest, 2011

construction contracts for a period exceeding one year, or several cycles of operation);

- payment does not produce any future economic advantage, or when future economic advantages do not entitle or cease to give the right to recognizing an asset in the Balance sheet(for example losses created by the impossibility of cashing receivables, or losses generated by the inability to recover the estimated initial value for assets);
- a debt that does not insure financing an asset appears (granting guaranties for sold goods, in which case the obligation created does not insure financing an asset).

In terms of **revenue**, they are recognized in the Gain and Loss account when there is an increase in future economic benefit generated by an increase in assets or a reduction of debt, and growth of future economic benefits can be measured reliably¹⁴. This means that recognition of income occurs simultaneously with the recognition of an additional growth of assets or decreases of debt in the Balance sheet.

High credibility of the assessment and increased probability of achieving economic benefits is insured when linking recognition of revenue to the changes in assets or debts.

Revenue recognition criteria set out in the IASB, are complemented by international standard **IAS 18 Revenue** that details the various categories of income:

- for recognizing revenue from the sale of goods, in addition to the criteria set out in the IASB, the standard adds the following criteria: transfer to the buyer of risks and rewards associated with the asset, the selling entity does not participate in the management and does not keep the control of the goods transferred; it is likely that the economic benefits associated with the transaction to belong to the entity; the costs regarding the transaction to be reasonably evaluated¹⁵;
- *the revenue from contracts of service provision* is recognized while the contract is performed, if the conditions of recognizing income are fulfilled, if we can establish a reliable manner in which to finalize the contract, and if the costs can be reasonably evaluated. This recognition method called *percentage method of execution* is applied when the legal rights, means of payment and settlement conditions of each party are settled. Only costs that reflect services rendered to a particular date are recognized as expenses in the Gain and Loss account. Any means of payment already received will be recognized as a debt in the Balance sheet rather than income.

To reflect the economic reality of *the revenue recognition criteria have to be applied separately to each transaction*. Thus, if the selling price of a product includes an identifiable amount for mandatory subsequent services, this amount is recorded as revenue in advance and should be recognized as current income during the period in which the service is performed.

¹⁴ International Standards of Financial Reporting (IFRS) – Official rules issued at January the First 2011, CECCAR, Bucharest, 2011

¹⁵ idem

Same standard specifies that during the *moment of income registration*, their recognition criteria have to consider the probability that the entity will have future economic benefit that will be evaluated correctly.

In addition, revenue will include only those economic benefits received or to be received by an entity in *its own name*. Given this specification, it is not recognized as revenue the amounts collected on behalf of third parties, and here we can exemplify VAT collected on behalf of the State, or amounts collected from the sale of goods by intermediaries.

Interest revenue and dividends are recognized as income as follows:

- *an interest* shall be recognized periodically in proportion to the interest rate required to maintain future cash inflows,
- and *dividends* shall be recognized when the shareholder's right to cash it is set.
- It should also be noted that when considering the concepts of income and expense we exclude the entity relationships with its owners. *So they are not recognized as revenue contributions* from owners, or *as expenses the distributions to owners*. This applies in both the international accounting referential, and the American one, bringing closer in some measure the coverage of the structures between the two referential financial statements.

In comparison to IASB, the American conceptual framework through *SFAC 5 Recognition and Measurement in Financial Statements of Business Enterprises* specifies even more the recognition process of financial elements bringing supplementary details to this regard.

So, the American standards make supplementary specifications regarding recognizing income from present activities and earnings, presenting *two factors*¹⁶ to be taken into consideration:

- *revenue to be made when* – obtaining cash from the sale of goods, services and income is achievable - when in exchange for goods sold to obtain other assets instead of cash, but that can be converted into cash without restrictions;
- *revenue to be earned when* - rule specify what is meant by *earned income generated by activities*, namely those reflecting supply of goods, services, or other activities that constitute important operations or specific to the activity object of the entity, and as a result of these *activities revenue is considered earned* when the entity has made a substantial effort to obtain economic benefits.

Such details as those presented above, do not appear clearly in the international standards, thus leaving freedom to professional reasoning.

5. CONCLUSIONS

IASB does not consider the element definition as a recognition criterion like the American one, but classifies the element in that definition.

¹⁶ SFAC 5 Recognition and Measurement in Financial Statements of Business Enterprises, 2011

FASB does not define clearly the concept of probability through recognition criteria as IASB does.

The American conceptual framework specifies recognition criteria approaching aspects of international quality of information for elements in the financial statements, exceeding recognition in the financial statements.

Assessment of the probability for generating future economic benefits linked to the degree of uncertainty has a significant influence in the recognition process and a more accurate positioning of an item in the financial statements.

For these reasons it is necessary that guidelines given by specific standards to be more complete, to cover a wider range of situations derived from an entity practical activities, and for situations that are not covered to issue new standards.

For a more accurate positioning of an item in financial statements, general guidelines given by conceptual framework regarding recognition is not enough, they have to be more complete, more specific.

In **national accounting legislation**, , we find the same recognition criteria for items presented in the financial statements as those specified by the IASB conceptual framework, but going into detail on each class of assets, liabilities, equity, income, expenses there is little guidance on their recognition in different situations and at different times of recognition compared to the guide found in accounting standards, therefore we support the improvement of national legislation with details of IAS / IFRS regarding the recognition elements.

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