NZ ACCOUNTING
STANDARDS
BOARD

New Zealand *Conceptual Framework forFinancial Reporting (PBE)*

(NZ *Framework (PBE)*)

Issued November 2012

This New Zealand *Conceptual Framework for Financial Reporting (PBE)* (NZ *Framework (PBE)*) was issued by the New Zealand Accounting Standards Board of the External Reporting Board as authoritative support under the Financial Reporting Act 1993.

This NZ *Framework (PBE)* consists of two parts:

- [Not used]; and
- For public benefit entities only, Part B which is the New Zealand *Framework for the Preparation and Presentation of Financial Statements (PBE)*

In the Appendix to this NZ *Framework (PBE)* the Rationale for the decision to adopt a two-part framework is provided.

As at 1 December 2012, this NZ *Framework (PBE)* is identical to Part B of the New Zealand *Conceptual Framework for Financial Reporting* as applied by public benefit entities. Part B of the NZ *Framework* applied by public benefit entities prior to adoption of this NZ *Framework (PBE)* is available on the Archived Standards page of the External Reporting Board (XRB) website at xrb.govt.nz

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NEW ZEALAND CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING (PBE)

PART A – PROFIT-ORIENTED ENTITIES ONLY

[NOT USED]

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NZ FRAMEWORK (PBE): PART B – PUBLIC BENEFIT ENTITIES ONLY

Part B of the New Zealand *Conceptual Framework for Financial Reporting (PBE)* is set out in paragraphs B1–B110. Part B of the NZ *Framework (PBE)* is based on the IASB *Framework for the Preparation and Presentation of Financial Statements* (1989) (IASB *Framework* (1989)) initially issued by the International Accounting Standards Committee (IASC) and subsequently adopted by the International Accounting Standards Board (IASB).

Any additional material is shown with grey shading. The paragraphs are denoted with "NZ" and identify the types of entities to which the paragraphs apply.

Part B of this NZ *Framework (PBE)* uses the terminology adopted in International Financial Reporting Standards[*] (IFRSs) to describe the financial statements and other elements. NZ IAS 1 (PBE) *Presentation of Financial Statements* paragraph 5 explains that entities seeking to apply this NZ *Framework (PBE)* may need to amend the descriptions used for particular line items in the financial statements and for the financial statements themselves. For example, profit/loss may be referred to as surplus/deficit and capital or share capital may be referred to as equity.

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[*] The term IFRSs is defined in NZ IFRS 1 (PBE) *First-time Adoption of NZ IFRS PBE* (NZ IFRS 1 (PBE)).

Introduction to Part B of the NZ *Framework (PBE)*

Part B of this NZ *Framework (PBE)* is based on the IASB *Framework* (1989). Part B of this NZ *Framework (PBE)* is an essential component of New Zealand financial reporting pronouncements as it establishes definitions and recognition criteria that are applied in other pronouncements.

The IASB *Framework* (1989) was developed for application by profit-oriented entities. Part B of this NZ *Framework (PBE)* includes material additional to that in the IASB *Framework* (1989) to ensure that it can be applied by public benefit entities required to prepare general purpose financial statements that comply with generally accepted accounting practice in New Zealand. In order to preserve the integrity of the IASB *Framework* (1989) and to enable Part B of this NZ *Framework (PBE)* to be readily updated for future revisions of the IASB *Framework* (1989), changes to the text of the IASB *Framework* (1989) have been minimised.

In adopting the IASB *Framework* (1989) for application as Part B of the NZ *Framework (PBE)*, the following changes have been made.

(a) The discussion in paragraphs B1–B4 has been revised to reflect the purpose of Part B of the NZ *Framework (PBE)* and the role of the FRSB (paragraphs NZ B4.1 to NZ B4.4).

(b) The description of a complete set of financial statements has been amended for consistency with NZ IAS 1 (PBE) *Presentation of Financial Statements* (paragraph B7).

(c) A discussion acknowledging the role of non-financial and supplementary information has been included (paragraph NZ B7.1).

(d) Additional paragraphs have been inserted to acknowledge the range of entities that are required to prepare general purpose financial statements (paragraphs NZ B8.1 to NZ B8.3).

(e) A discussion of two additional users of financial statements (funders or financial supporters, and elected or appointed representatives) has been inserted (paragraph NZ B9.1).

(f) A discussion of the role of financial statements in demonstrating accountability has been included (paragraphs NZ B14.1 and NZ B14.2).

(g) A discussion of various types of non-financial and supplementary information has been included (paragraphs NZ B20.1 to NZ B20.8).

(h) Additional guidance for public benefit entities in respect of materiality has been inserted (paragraph NZ B30.1).

(i) An additional paragraph discussing “future economic benefits” and “service potential” has been inserted (paragraph NZ B49.1).

(j) Additional guidance has been inserted stating that in the context of public benefit entities, references to contributions from (or distributions to) equity participants

should be read as contributions from (or distributions to) equity holders acting in their capacity as equity holders (paragraph NZ B70.1).

(k) A brief discussion of the elements of non-financial statements has been included. Part B of the NZ *Framework (PBE)* requires that the quality of the information presented in non-financial and supplementary information should be considered with regard to the qualitative characteristics and constraints on those qualitative characteristics discussed in paragraphs B24 to B45 of Part B of the NZ *Framework (PBE)* (paragraphs NZ B101.1 to NZ B101.3).

(l) A brief rationale for the New Zealand specific sections has been included as an Appendix to Part B of the NZ *Framework (PBE)*.

Introduction to Part B

Purpose and status

B1-B4 [Paragraphs 1 to 4 of the IASB *Framework* (1989) are not reproduced—they have been replaced by paragraphs NZ B4.1 to NZ B4.4 which explain the purpose of Part B of this NZ *Framework (PBE)*.]

NZ B4.1 Part B of this NZ *Framework (PBE)* sets out the concepts that underlie the preparation and presentation of financial statements by public benefit entities required to prepare general purpose financial statements that comply with Generally Accepted Accounting Practice in New Zealand (NZ GAAP).[*],[†] The IASB *Framework* (1989), on which Part B of this NZ *Framework (PBE)* is based, focuses on financial statements. However, financial statements are often presented in conjunction with other information. A financial report may include financial statements, non-financial statements and supplementary information. In adopting Part B of this NZ *Framework (PBE)* for application to New Zealand public benefit entities, and particularly to ensure the relevance of Part B of the NZ *Framework (PBE)* for public benefit entities, certain aspects have been extended to acknowledge the role of non-financial and supplementary information. These paragraphs are clearly marked. The purpose of Part B of this NZ *Framework (PBE)* is to:

(a) assist the New Zealand National Standard Setter in its role as a national standard setter with formal liaison status with the IASB:

  (i) in the development of future International Financial Reporting Standards (IFRSs);

  (ii) in the review of existing IFRSs; and

  (iii) in promoting harmonisation of accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs;

(b) assist the New Zealand National Standard Setter in developing NZ IFRS PBE;

[*] The New Zealand *Preface* (NZ *Preface*), paragraph 17, contains an explanation of the term general purpose financial statements.

[†] A range of entities are required by legislation (for example, Financial Reporting Act 1993, Public Finance Act 1989, Local Government Act 2002, to prepare financial statements in accordance with GAAP (as defined in the Financial Reporting Act or a modified version of that definition).

(c) in the absence of a NZ IFRS PBE, assist the New Zealand National Standard Setter in developing a Financial Reporting Standard (PBE);

(d) assist preparers of financial statements in applying Standards* and in dealing with topics that have yet to form the subject of a Standard;

(e) assist auditors in forming an opinion as to whether financial statements conform with Standards; and

(f) assist users of financial statements in interpreting the information contained in financial statements.

NZ B4.2 Part B of this NZ *Framework (PBE)* is not a Standard and hence does not define standards for any particular definition, recognition, measurement or disclosure issue. Nothing in Part B of this NZ *Framework (PBE)* overrides any specific Standard. The NZ *Preface* outlines the requirements of NZ IAS 8 (PBE) *Accounting Policies, Changes in Accounting Estimates and Errors* (NZ IAS 8 (PBE)) in relation to developing accounting policies in the absence of a specific Standard or an interpretation of a Standard that specifically applies to a transaction, other event or condition.

NZ B4.3 The New Zealand National Standard Setter recognises that in a limited number of cases there may be a conflict between Part B of this NZ *Framework (PBE)* and a specific Standard. In those cases where there is a conflict, the requirements of the Standard prevail over those of Part B of this NZ *Framework (PBE)*. As, however, the IASB and the New Zealand National Standard Setter will be guided by their respective *Framework*s in the development of future Standards and in their review of existing Standards, the number of cases of conflict between Part B of this NZ *Framework (PBE)* and Standards will diminish through time.

NZ B4.4 Part B of this NZ *Framework (PBE)* will be revised from time to time.

Scope

B5 Part B of this NZ *Framework (PBE)* deals with:

(a) the objective of financial statements;

(b) the qualitative characteristics that determine the usefulness of information in financial statements;

(c) the definition, recognition and measurement of the elements from which financial statements are constructed; and

(d) concepts of capital and capital maintenance.

* Unless otherwise stated, references to Standards in this document should be read as references to both NZ IFRS PBE (as defined in NZ IFRS 1 (PBE) *First-time Adoption of NZ IFRS PBE*) and other Financial Reporting Standards applicable to public benefit entities that have adopted NZ IFRS PBE.

B6 Part B of this NZ *Framework (PBE)* is concerned with general purpose financial statements (hereafter referred to as "financial statements"), including consolidated financial statements. Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes, are outside the scope of Part B of this NZ *Framework (PBE)*. Nevertheless, Part B of this NZ *Framework (PBE)* may be applied in the preparation of such special purpose reports where their requirements permit.

B7 Financial statements form part of the process of financial reporting. A complete set of financial statements normally includes a balance sheet, an income statement, a statement of cash flows and a statement of changes in equity, and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about industrial and geographical segments and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in an annual or interim report. [Amended in Part B of NZ *Framework (PBE)* for consistency with the explanation of a complete set of financial statements in NZ IAS 1 (PBE) *Presentation of Financial Statements*.]

NZ B7.1 A financial report may include financial statements, non-financial statements such as statements of service performance and supplementary information which is additional to the information in financial statements.

B8 Part B of this NZ *Framework (PBE)* applies to the financial statements of public benefit entities. A reporting entity* is an entity for which there are users who rely on the financial statements as their major source of financial information about the entity. [Amended in Part B NZ *Framework (PBE)*—first sentence adapted to remove reference to commercial entities.]

* This definition of a reporting entity differs to that used in the Financial Reporting Act 1993. The Financial Reporting Act 1993 defines a reporting entity as:
(a) An issuer; or
(b) A company, other than an exempt company; or
(c) A person that is required by any Act, other than this Act, to comply with this Act as if it were a reporting entity. The definition in the Financial Reporting Act is used to establish a legal requirement for certain entities to report in accordance with NZ GAAP.

NZ B8.1 An obligation to prepare general purpose financial statements often derives from legislation, regulations, common law, an entity's constitution or contractual arrangements.

NZ B8.2 Types of reporting entities include companies, government departments, Crown entities, local authorities, and other not-for-profit entities including trusts and charities. New Zealand Standards contain requirements in relation to all entities. Certain requirements within Standards apply to some entities only (for example, public benefit entities).

NZ B8.3 The application of Part B of this NZ *Framework (PBE)* is outlined in paragraph NZ B4.1.

Users and their information needs

B9 The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:

(a) *Investors.* The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.

(b) *Employees.* Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

(c) *Lenders.* Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(d) *Suppliers and other trade creditors.* Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.

(e) *Customers.* Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.

(f) *Governments and their agencies.* Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities

of entities, determine taxation policies and as the basis for national income and similar statistics.

(g) *Public.* Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways, including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

NZ B9.1 The users of financial statements in the New Zealand context also include funders and financial supporters (for example, taxpayers and donors), and elected or appointed representatives. Their needs include the following:

(a) Funders or financial supporters. Funders or financial supporters provide a source of cash and/or resources that does not generate a direct return (unlike a loan) and is not provided in exchange for direct benefits (goods or services) for themselves. The funder or financial supporter generally provides taxation, grants or donations to the entity. This class of users includes the past, present and potential funders and financial supporters of the entity. When funders and financial supporters provide resources that are used to supply goods and services to third parties they are interested in the quality of the goods and services produced and whether the goods and services were produced in accordance with relevant contracts or agreements. As with customers that purchase goods and services directly from an entity, funders and financial supporters are interested in information about the continuance of an entity, such as its sustainability, flexibility and vulnerability.

(b) Elected or appointed representatives. Members of Parliament and local authority councillors represent their respective electorates. Members of a governing body represent the interests of specific groups or entities. Elected or appointed representatives use financial statements to assess an entity's actual achievement against its formal objectives and targets and hold an entity accountable for its performance. Such users are likely to use financial statements in conjunction with non-financial information. Where the elected or appointed representatives have responsibility for the long-term financial performance of an entity they may also be interested in its sustainability, flexibility and vulnerability.

B10 While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

B11 The management[*] of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of Part B of this NZ *Framework (PBE)*. Nevertheless, published financial statements are based on the information used by management about the financial position, performance and changes in financial position of the entity. [Footnote on definitions of management inserted in Part B of NZ *Framework (PBE)*.]

The objective of financial statements

B12 The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.

B13 Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information.

B14 Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace the management.

[*] NZ IAS 24 (PBE) *Related Party Disclosures* (NZ IAS 24 (PBE)) defines "key management personnel" as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

NZ B14.1 In addition to making economic decisions, as discussed in paragraphs B12 to B14, users of financial statements of New Zealand entities may also be interested in how well an entity has demonstrated its accountability in relation to a range of obligations including the entity's compliance with legislation, regulations, common law and contractual arrangements.

NZ B14.2 An entity may demonstrate its accountability in relation to its obligations in its financial statements or in non-financial statements and other supplementary information. Accountability requires that an entity reflect the nature and dimensions of performance that are relevant to the entity by:

(a) identifying the objectives and targets (financial or non-financial) normally established by formal process; and

(b) recognising, measuring and disclosing actual achievements in relation to those objectives and targets.

Financial position, performance and changes in financial position

B15 The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an entity to pay its employees and suppliers, meet interest payments, repay loans and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and changes in financial position of an entity.

B16 The financial position of an entity is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the entity and its capacity in the past to modify these resources is useful in predicting the ability of the entity to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the entity; it is also useful in predicting how successful the entity is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the entity to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future after taking account of financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

B17 Information about the performance of an entity, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting

the capacity of the entity to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the entity might employ additional resources.

B18 Information concerning changes in the financial position of an entity is useful in order to assess its investing, financing and operating activities during the reporting period. This information is useful in providing the user with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. In constructing a statement of changes in financial position, funds can be defined in various ways, such as all financial resources, working capital, liquid assets or cash. No attempt is made in Part B of this NZ *Framework (PBE)* to specify a definition of funds.

B19 Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in an income statement. Information about changes in financial position is provided in the financial statements by means of a separate statement.

B20 The component parts of the financial statements interrelate because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose or provide all the information necessary for particular needs of users. For example, an income statement provides an incomplete picture of performance unless it is used in conjunction with the balance sheet and the statement of changes in financial position.

Non-financial and supplementary information

NZ B20.1 In order to assist users of financial statements in making economic decisions and in forming assessments of an entity's accountability for its obligations, an entity may provide a range of non-financial and supplementary information including:

(a) historical information;

(b) interpretive comment;

(c) prospective information;

(d) service performance information;

(e) information on compliance with legislation; and

(f) key value driver information.

NZ B20.2 Historical information reports on past transactions and events.

NZ B20.3 Interpretive comment reports on reported results. For example, narrative comment could explain the relationship between material changes in financial elements and the entity's history, objectives, current activities and changes in the external environment (including the economic, physical and social environment) or objectives.

NZ B20.4 Prospective information reports on the potential effects of past transactions and events and the likely effects of proposed transactions and events. It is commonly disclosed in narrative and/or quantitative form. For example, narrative information could provide an assessment of the entity's future impacts and prospects, focusing on how anticipated changes in the external environment (including the economic, physical and social environment) might affect results, liquidity and risk. In contrast, quantitative information could take the form of predictive results for anticipated economic, social or environmental effects based on proposed courses of action.

NZ B20.5 Service performance is the term used to describe an entity's performance in meeting its objectives of supplying goods and services. An entity's service performance is assessed by comparing the entity's service performance results with its service performance objectives. Service performance objectives and results are reported in non-financial terms, such as quantities of goods and services provided.

NZ B20.6 An entity may have an obligation to report service performance when it receives funding from one party (the ratepayer, the donor etc) but delivers (or arranges to deliver) outputs (goods and services) to third parties (the general public, the disabled etc). This relationship occurs when the entity has the coercive power to tax, rate or levy to obtain public funds, or the entity receives donations from the public. For example, this relationship exists where the entity reporting is a charity that receives donations from the public but provides services to third parties such as the disabled. Similarly, a local authority may charge rates to property owners but provide a park and other services to the general public as third parties.

NZ B20.7 Entities have a range of legal obligations, including compliance with legislation governing health and safety, human resources and protection of the environment. Such obligations may impact upon financial performance, or information from the financial statements may be used to demonstrate an entity's commitment to these obligations. In addition, some entities have legal obligations to operate in accordance with approved budgets.

NZ B20.8 Non-financial information might also focus on identifying and describing the key business, operational and strategic factors facing an entity. Key value driver information can encompass a broad range of measures including sales growth, profit, client satisfaction, measures of the quality of goods and services, and supplier relationships.

Notes and supplementary schedules

B21 The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement. They may include disclosures about the risks and uncertainties affecting the entity and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about geographical and industry segments and the effect on the entity of changing prices may also be provided in the form of supplementary information.

Underlying assumptions

Accrual basis

B22 In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or its equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past transactions involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going concern

B23 The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Qualitative characteristics of financial statements

B24 Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

B25 An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

Relevance

B26 To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

B27 The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the entity to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the entity would be structured or the outcome of planned operations.

B28 Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, security price movements and the ability of the entity to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed.

Materiality

B29 The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.

B30 Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

NZ B30.1 In addition to the guidance in paragraph B30, omissions or misstatements of items are material if they could, individually or collectively, influence the decisions or assessments of users made on the basis of the financial statements.

Reliability

B31 To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

B32 Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the entity to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful representation

B33 To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria.

B34 Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although most entities generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance over form

B35 If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

Neutrality

B36 To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

B37 The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Completeness

B38 To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Comparability

B39 Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.

B40 An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same entity from period to period and by different entities. Compliance with NZ GAAP, including the disclosure of the accounting policies used by the entity, helps to achieve comparability. [Amended in Part B of NZ *Framework (PBE)* - final sentence, reference to NZ GAAP inserted.]

B41 The need for comparability should not be confused with mere uniformity and accounting standards. It is not appropriate for an entity to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an entity to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

B42 Because users wish to compare the financial position, performance and changes in financial position of an entity over time, it is important that the financial statements show corresponding information for the preceding periods.

Constraints on relevant and reliable information

Timeliness

B43 If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

Balance between benefit and cost

B44 The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared; for example, the provision of further information to lenders may reduce the borrowing costs of an entity. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between qualitative characteristics

B45 In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

True and fair view/fair presentation

B46 Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity. Although Part B of this NZ *Framework (PBE)* does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.[*]

The elements of financial statements

B47 Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the income statement are income and expenses. The statement of changes in financial position usually reflects income statement elements and changes in balance sheet elements; accordingly, Part B of this NZ *Framework (PBE)* identifies no elements that are unique to this statement.

[*] For details of regulatory requirements in New Zealand, refer to the Financial Reporting Act 1993, the Public Finance Act 1989 and the Local Government Act 2002. Refer also to NZ IAS 1 paragraph 19.

B48 The presentation of these elements in the balance sheet and the income statement involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the entity in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial position

B49 The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

(a) An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

(b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

(c) Equity is the residual interest in the assets of the entity after deducting all its liabilities.

NZ B49.1 Part B of this NZ *Framework (PBE)* uses the term "future economic benefits". This term is to be read as having the same meaning as the term "service potential". Assets provide a means for entities to achieve their objectives. Assets that are used to deliver goods and services in accordance with an entity's objectives but which do not directly generate net cash inflows are often described as embodying "service potential." Assets that are used to generate net cash inflows are often described as embodying "future economic benefits."

B50 The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs B82 to B98. In particular, the expectation that future economic benefits will flow to or from an entity must be sufficiently certain to meet the probability criterion in paragraph B83 before an asset or liability is recognised.

B51 In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease

gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the lessee's balance sheet.

B52 Balance sheets drawn up in accordance with current Standards may include items that do not satisfy the definitions of an asset or liability and are not shown as part of equity. The definitions set out in paragraph B49 will, however, underlie future reviews of existing Standards and the formulation of further Standards.

Assets

B53 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. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

B54 An entity usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flow of the entity. Cash itself renders a service to the entity because of its command over other resources.

B55 The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be:

(a) used singly or in combination with other assets in the production of goods or services to be sold by the entity;

(b) exchanged for other assets;

(c) used to settle a liability; or

(d) distributed to the owners of the entity.

B56 Many assets, for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity.

B57 Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property. Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.

B58 The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or

events may generate assets; examples include property received by an entity from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

B59 There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the entity may satisfy the definition of an asset.

Liabilities

B60 An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

B61 A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.

B62 The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

(a) payment of cash;

(b) transfer of other assets;

(c) provision of services;

(d) replacement of that obligation with another obligation; or

(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

B63 Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade payables (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An entity may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

B64 Some liabilities can be measured only by using a substantial degree of estimation. Some entities describe these liabilities as provisions. In some countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly so as to include only amounts that can be established without the need to make estimates. The definition of a liability in paragraph B49 follows a broader approach. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

B65 Although equity is defined in paragraph B49 as a residual, it may be sub-classified in the balance sheet. For example, in a corporate entity, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an entity have differing rights in relation to the receipt of dividends or the repayment of capital.

B66 The creation of reserves is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection from the effects of losses. Other reserves may be established if national tax law grants exemptions from, or reductions in, taxation liabilities when transfers to such reserves are made. The existence and size of these legal, statutory and tax reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

B67 The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the entity or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the entity as a whole on a going concern basis.

B68 Reporting entities may include sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory *Framework* for such entities is often different from that applying to corporate

entities. For example, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of Part B of this NZ *Framework (PBE)* that deal with equity are appropriate for such entities. [Amended in Part B of NZ *Framework (PBE)*—first sentence amended by deleting reference to "commercial, industrial and business activities"—New Zealand reporting entities engage in a wider range of activities than this.]

Performance

B69 Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the entity in preparing its financial statements. These concepts are discussed in paragraphs B102 to B110.

B70 The elements of income and expenses are defined as follows:

(a) 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.

(b) 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.

NZ B70.1 In the context of public benefit entities, references to contributions from, or distributions to, equity participants should be read as contributions from, or distributions to, equity holders acting in their capacity as equity holders.

B71 The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that would need to be met before they are recognised in the income statement. Criteria for the recognition of income and expenses are discussed in paragraphs B82 to B98.

B72 Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the

nature of the entity and its operations. Items that arise from the ordinary activities of one entity may be unusual in respect of another.

B73 Distinguishing between items of income and expense and combining them in different ways also permits several measures of entity performance to be displayed. These have differing degrees of inclusiveness. For example, the income statement could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

B74 The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

B75 Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in Part B of this NZ *Framework (PBE)*.

B76 Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long term assets. When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Gains are often reported net of related expenses.

B77 Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result from the settlement of liabilities. For example, an entity may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

B78 The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, cost of services provided, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment. [Second sentence amended in Part B of NZ *Framework (PBE)* – the words "cost of services provided" were inserted.]

B79 Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from

other expenses. Hence, they are not regarded as a separate element in Part B of this NZ *Framework (PBE).*

B80 Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, for example, those arising from the effects of increases in the rate of exchange for a foreign currency in respect of the borrowings of an entity in that currency. When losses are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Losses are often reported net of related income.

Capital maintenance adjustments

B81 The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs B102 to B110 of Part B of this NZ *Framework (PBE).*

Recognition of the elements of financial statements

B82 Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph B83. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals. Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

B83 An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability.

B84 In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraphs B29 and B30. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The probability of future economic benefit

B85 The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. The concept is in keeping with the uncertainty that characterises the environment in which an entity operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable owed by an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognised.

Reliability of measurement

B86 The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs B31 to B38 of Part B of this NZ *Framework (PBE)*. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible for the claim to be measured reliably, it should not be recognised as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.

B87 An item that, at a particular point in time, fails to meet the recognition criteria in paragraph B83 may qualify for recognition at a later date as a result of subsequent circumstances or events.

B88 An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and changes in financial position of an entity by the users of financial statements.

Recognition of assets

B89 An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

B90 An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the income statement. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of liabilities

B91 A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of income

B92 Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

B93 The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in Part B of this NZ *Framework (PBE)*. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of expenses

B94 Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities

or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).

B95 Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under Part B of this NZ *Framework (PBE)* does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

B96 When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as property, plant, equipment, goodwill, patents and trademarks; in such cases the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

B97 An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

B98 An expense is also recognised in the income statement in those cases when a liability is incurred without the recognition of an asset, as when a liability under a product warranty arises.

Measurement of the elements of financial statements

B99 Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.

B100 A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

(a) *Historical cost.* Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash

equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) *Current cost.* Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) *Realisable (settlement) value.* Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

(d) *Present value.* Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

B101 The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value. Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

THE ELEMENTS OF NON-FINANCIAL AND SUPPLEMENTARY INFORMATION

NZ B101.1 The elements reported in non-financial and supplementary information and how these elements are defined will depend on a range of factors, including:

(a) legislative requirements; and

(b) the entity's specific objectives, activities and accountability obligations.

NZ B101.2 For example, the elements of service performance are defined as inputs, outputs and outcomes.[*]

NZ B101.3 The quality of the information presented in non-financial and supplementary information should be considered with regard to the qualitative characteristics and constraints on those qualitative characteristics discussed in paragraphs B24 to B45 of Part B of this NZ *Framework (PBE).*

[*] Technical Practice Aid No. 9 *Service Performance Reporting* (TPA-9) provides guidance on service performance reporting.

Concepts of capital and capital maintenance

Concepts of capital

B102 A financial concept of capital is adopted by most entities in preparing their financial statements. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the entity. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the entity based on, for example, units of output per day.

B103 The selection of the appropriate concept of capital by an entity should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the entity, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of capital maintenance and the determination of profit

B104 The concepts of capital in paragraph B102 give rise to the following concepts of capital maintenance:

(a) *Financial capital maintenance.* Under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) *Physical capital maintenance.* Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

B105 The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an entity's return on capital and its return of capital; only inflows of assets in excess

of amounts needed to maintain capital may be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income the residual amount is a net loss.

B106 The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the entity is seeking to maintain.

B107 The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the entity. In general terms, an entity has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

B108 Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

B109 Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the entity are viewed as changes in the measurement of the physical productive capacity of the entity; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

B110 The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. Part B of this NZ *Framework (PBE)* is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is not the intention of the FRSB or the IASB to prescribe a particular model other than in exceptional circumstances, such as for those entities reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments. [Amended in Part B of NZ *Framework (PBE)*—reference to FRSB inserted.]

Appendix to Part B
Rationale for NZ Changes to the IASB Framework (1989) and IFRSs

This Appendix provides background to the changes made to the IASB Framework (1989) in adopting the IASB Framework (1989) for application as Part B of the NZ Framework (PBE). It does not form part of Part B of the NZ Framework (PBE).

1 The ASRB announced in December 2002 that New Zealand entities would be required to apply IFRSs, issued by the IASB, for annual accounting periods commencing on or after 1 January 2007, but would have the option to adopt for accounting periods commencing on or after 1 January 2005.

2 The IASB *Framework* (1989), along with other IFRSs, is designed to be applied to profit-oriented entities. IFRSs are not designed to be applied to public sector entities or other non-profit entities (collectively referred to as public benefit entities) or to profit-oriented entities reporting on broader economic, social and environmental performance and resources.

3 In adopting the IASB *Framework* (1989) for application as Part B of the NZ *Framework (PBE)*, applicable to the general purpose financial statements public benefit entities, the FRSB has acted in accordance with the guidelines developed by the ASRB regarding matters to be considered in developing a New Zealand equivalent to an international pronouncement.

4 In considering the type of changes required, the FRSB considered the different needs of public benefit entities and profit-oriented entities. New Zealand's experience suggests that standards need to pay particular attention in the following areas.

(a) Information to meet user needs: Stakeholders providing finance to public benefit entities are predominantly funders and financial supporters rather than investors. These groups are primarily seeking information for accountability purposes rather than information about their return on investment.

(b) Reporting entity definition: the boundary of the consolidated reporting entity may have distinctive features, particularly where legal instruments of ownership such as shares do not exist.

(c) Assets: In the public benefit sector special consideration needs to be given to the reporting of assets that do not generate cash, where there is little market evidence, and where the provision of an asset or the supply of benefits arising from the asset are provided at non-market rates.

(d) Liabilities: Rules established regarding the recognition of liabilities need to consider the situation where public benefit entities have commitments, whether general or specific, that do not arise out of market-style

transactions, and how to account for this sort of "non-exchange" transaction.

5 Many of the above issues are not unique to public benefit entities, but they may require more emphasis and consideration for the accounting standards to be relevant to public benefit entities and to ensure that the desired level of consistency in reporting by those entities is achieved.

6 The FRSB considered issuing the IASB *Framework* (1989) without public benefit material, and restricting its scope to profit-oriented entities, pending a more comprehensive review that would have provided additional consultation with constituents. Under this approach public benefit entities would have continued to apply the New Zealand *Statement of Concepts*. This approach reflected the inherent difficulty in developing a sector-neutral *Framework* from a document that has a profit focus. The FRSB determined not to take that approach because it assessed that the costs of doing so outweighed the benefits. Under that approach the *Statement of Concepts* would need to be amended to ensure that it provided an appropriate foundation for the New Zealand equivalents to IFRSs. The FRSB resolved to issue Part B of the NZ *Framework (PBE)* based on the IASB *Framework* (1989) but to review the NZ *Framework (PBE)* as appropriate as part of the review to consider any changes proposed by the IASB to the IASB *Framework* (1989).

7 In some cases the narrower scope of the IASB standards means that further development of the international standards would be needed for them to be relevant to public benefit entities. To the extent that New Zealand has not developed such guidance to date, the general approach taken by the FRSB in developing New Zealand equivalents to IFRSs has been to provide an exemption for public benefit entities from certain requirements and to resolve to either work with the IASB to develop more suitable comprehensive guidance, or to develop specific public benefit entity application guidance itself. At the time Part B of this NZ *Framework (PBE)* was approved, instances where this approach has been taken include:

(a) non-exchange revenue—where the IASB is updating IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and the International Public Sector Accounting Standards Board of the International Federation of Accountants (IFAC IPSASB) is also developing guidance;

(b) social policy obligations—where the IFAC IPSASB is currently developing guidance;

(c) impairment of non-cash generating assets—where an assessment of the applicability of the recently issued International Public Sector Accounting Standard IPSAS 21 *Impairment of Non-Cash-Generating Assets* is required; and

(d) segment reporting—where revenue and risk based segments are not considered appropriate, but the integration of segment reporting with service performance information requires further consideration.