European Journal of Accounting, Auditing and Finance Research
Vol.10, No. 7, pp.17-30, 2022
Print ISSN: 2053-4086(Print),
Online ISSN: 2053-4094(Online)

Application of Professional Judgement in International Financial Reporting Standards

Clement Chiahemba Ajekwe
Benue State University

Citation: Clement Chiahemba Ajekwe (2022) Application of Professional Judgement in International Financial Reporting Standards, *European Journal of Accounting, Auditing and Finance Research*, Vol.10, No. 7, pp.17-30

ABSTRACT: *This essay accesses the use of professional judgements in the preparation and implementation of international financial reporting standards by preparers of financial statements. The article samples some domains of professional judgement in financial reporting contained in the Conceptual Framework for Financial Reporting (2018) and selected IAS/IFRS to demonstrate how judgement is exercised in the preparation and presentation of principles-based standards. The sampled domains or action areas for the exercise of professional judgement are going concern, materiality, accruals accounting, accounting policies, presentation/disclosure, measurements, estimates, recognition/de-recognition, classifications and revenue recognition. From the analyses of these domains, the essay concludes that (i) the exercise of professional judgement is a sine qua non in the implementation of IFRSs; and by extension, the ability to exercise professional judgement is not only the key skill for preparers of PBS-based financial statements; it is also the hallmark of an accounting professional.*

KEYWORDS: Professional judgements, domains of professional judgement, principles-based standards, financial reporting, IFRS Conceptual Framework for Financial Reporting

INTRODUCTION

The international financial reporting standards (IFRS) are 'principles-based' standards (PBS) that have the following characteristics: (i) each standard is drafted in clear, concise and plain language consistent with the objectives set in the overarching, coherent *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*) that unifies the accounting system as a whole; (ii) each standard states its accounting/financial reporting objective(s); financial statement preparers apply their judgment to decide how to fulfil the objective(s) contained in the particular standard in a manner that simultaneously responds to users' needs for clarity and transparency and faithfully reflects the economic reality of transactions, other events and conditions, and not a mere reflection of their legal form; (iii) information from PBSs are specifically defined and framed by the substantive objective(s) built into each pertinent standard; (iv) each standard clearly articulates the class of transactions to which they apply and so preparers have a structure and domain within which to make their judgements and in determining the appropriate accounting for the company's transactions (PWC, 2008; SEC, 2003). Consequently, IFRSs tend to have limited implementation

guidance in contrast to the detailed implementation guidance contained in 'rule-based' standards such as the US's generally accepted accounting principles (GAAP). In other words, the IFRSs are not intended to be a comprehensive code of rigid rules that supersede the exercise of informed judgement; the preparer of financial statements relies on his/her professional judgement and integrity to ensure that a company's published statements fairly present the financial position, performance and cash flows of the economic entity (Elliot & Elliot, 2009: 106; ICAS, 2012). Hence, the principles contained in the *Conceptual Framework* and IFRSs provide accountants with the structure and domain within which to apply professional judgement and the reporting of the underlying economic substance of transactions, conditions and events of entities, in their financial statements. This essay samples and discusses ten 'domains of professional judgement in financial reporting. The article is organised as follows: the next section clarifies the concept of professional judgement in financial reporting; section 3 identifies and explains judgemental activities and/or decisions in the course of preparing IFRS-compliant financial statements. Section 4 samples and discusses ten domains of professional judgement for financial reporting contained in the *Conceptual Framework* (2018) and in selected IAS/IFRS standards; section 5 concludes the paper.

Concept of Professional Judgement In Accounting

Professional judgement refers to the appropriate level of discretion an accounting professional exercises in applying accounting standard(s) to specific situations based on his/her accumulated knowledge, experience, objectivity and the relevant facts and circumstances within the stated accounting objective(s) of the applicable accounting standard(s). It is a combination of relevant knowledge, experience, objectivity, and integrity in choosing between accounting alternatives (Gibbins & Mason, 1988; Cormier &Magnan 2005). Judgements occur in a setting of uncertainty, in complex or novel transactions and/or under risk and could therefore differ between knowledgeable, experienced, and objective persons. Such differences do not, in themselves, suggest that one judgement is wrong and the other is correct. Two financial statements prepared by different equally competent accountants could conclude and report differently on similar circumstances. The differences may result from differences in the accounting methods used, accounting policies adopted or other judgements exercised. Such outcomes do not necessarily mean that one accountant is honest and the other fraudulent; nor that one conclusion is correct and the other is wrong. The criteria to use in evaluating judgements in accounting would be the reasonableness of the judgement(s) exercised, rather than the opinion(s) of the evaluator(s).

Activities That Commonly Require the Use of Judgements

The Advisory Committee on Improvements to Financial Reporting (2008: 89-91) identified some domain activities that commonly require professional judgements in the course of preparing IFRS-based financial statements:

1. Select appropriate accounting standard(s). An example of this situation is accounting for financial instruments. The four financial instruments standards, (i.e., IAS 32, IAS 39, IFRS 9 & IFRS 7), establish requirements for all aspects of accounting for financial instruments, including distinguishing debt from equity, offsetting in the financial position statement, recognition, de-recognition, measurement, hedge accounting and disclosure. For annual reporting periods

beginning on or after 1 January 2018, IFRS 9 replaces IAS 39. However, for some preparers, IAS 39 will remain relevant (for example insurers who apply the IFRS 4 deferral of IFRS 9). On transition to IFRS 9 entities may also continue to apply IAS 39 hedge accounting. In addition, requirements for fair value measurement and disclosures are covered by IFRS 13. Selecting the appropriate accounting standard(s) for the various situations and circumstances could pose a complex judgement to make, and one on which experienced accounting professionals could have legitimate differing, yet acceptable, opinions.

2. Implementation of an accounting standard. After the correct accounting standard(s) is/are identified, there are judgements to be made during its implementation. For example, in hedge accounting, several judgements are made including, determining if a hedge is effective, if a lease is an operating or a capital lease, what inputs and methodology/methodologies should be utilized in a fair value calculation, etc. Implementation judgements can be assisted by the guidance issued in the standards, directives of regulators, and other bodies. However, the provision of guidance could increase the complexity of selecting the correct accounting standard(s), as demonstrated by the issued guidance on derivatives. Furthermore, the financial instruments standards, for example, use wordings such as "substantially all", "closely related", "where they are material," "generally", *etc*. The use of such qualifying language can increase the amount of judgement required to implement accounting standard(s).

3. In the absence of an applicable accounting standard. There are some transactions that may not readily fit into a particular accounting standard. Dealing with these "grey" areas is typically highly complex and requires a great deal of judgement and accounting expertise; IAS 8: *Accounting Policies, Changes in Accounting Estimates and Errors* covers such situation(s), i.e., where no IFRS specifically deals with a transaction, other event or condition. The standard mandates that, in the absence of an IFRS that specifically applies to a transaction, other event or condition, preparers of financial statements are entitled to use their judgements in developing and applying an accounting policy that results in information that is relevant, faithfully representative and reliable regarding economic realities of the situation(s) (IAS 8: 10–12).

4. Financial statement presentation. The appropriate method to present, classify and disclose the accounting for a transaction in a financial statement can be highly subjective requiring a great deal of judgement. IAS 1: *Presentation of Financial Statements* only mandates fair presentation of financial statements without prescribing a presentation format although there are minimum presentation and disclosure requirements which provide implementation guidance that contains illustrative examples of acceptable formats.

5. Estimating the actual amount to record. Even when there is little debate as to which accounting standard(s) to apply to a transaction; significant judgements may need to be made in estimating the actual amount to record. For example, opinions on the appropriate standard to account for loan losses or to measure impairments of assets may not differ; however, the assumptions and methodology used by management to actually determine the allowance for loan losses or to determine impairment of an asset can be a highly judgemental area.

6. Evaluating the sufficiency of supporting evidence for judgements. Making a judgement about the transaction(s) requires sufficient supporting evidence. In practice, evaluating the sufficiency of supporting evidence for a judgement is typically one of the most subjective and difficult

judgements to make. For example, judgement(s) in determining sufficient supporting evidence to estimate sales returns or to support loan collectability is very subjective.

Domains of Professional Judgements For Financial Reporting

The purpose of the *Conceptual Framework* is to help the International Accounting Standards Board (IASB) develop standards and to help preparers develop accounting policies when the standards do not provide relevant guidance. Thus, the *Conceptual Framework* identifies several "domains of professional judgement" that guide preparers, regulators and users of IFRS-based financial statements. Similarly, individual Standards also offer principles, invariably "domains of professional judgement", for guiding their implementation, which involve the exercise of professional judgement.

In this section, ten 'domains of professional judgement' including going concern assumption, materiality, accruals-basis accounting, accounting policies, presentation of and disclosure in financial statements, measurements, estimates, and recognition/de-recognition, classification and revenue recognition are sampled for discussion and analyses. These are some of the areas or activities explicitly mentioned[1] or areas that are implied within the *Conceptual Framework* (2018) and/or within the IFRSs mandating or calling for preparers to exercise judgement in the preparation of financial statements. These elements are discussed *ad seriatim*:

1. Going Concern Assumption. Financial statements are prepared on the going concern assumption, i.e., that the reporting entity will continue in operation for the foreseeable future with neither the intention nor the need to enter liquidation or to cease trading. If there is an intention or need to cease trading, this will be disclosed and the financial statements may have to be prepared on a different basis (*Conceptual Framework*,2018; IAS 1: 25). How an entity applies the going concern assumption requires the exercise of professional judgement and disclosure of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern'. In practice, therefore, judgements are required of both managers and auditors to consider all available information about the future to determine whether or not the going concern assumption is appropriate.

2. Materiality is an important concept in financial reporting that often requires judgement in the application of IFRS and that affects the recognition and measurement of assets, liabilities, income and expenses and their presentation and disclosure in financial statements. Omissions or misstatements of items are material if they could, individually or collectively, influence the

[1] Ștefan-Duicu and Ștefan-Duicu (2017) reckon that "professional judgement" is explicitly mentioned 32 times in IAS/IFRS; similarly, Bialkowska and Martin (2005) determined that current IFRSs mention the "application of judgment" 45 times.

economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor (IAS 1: 7; IAS 8:5-6).. In other ways, materiality is an entity-specific aspect of relevance based on the nature and/or magnitude of the items to which the information relates in the context of an individual entity's financial report. Consequently, in the absence of neither a specified uniform quantitative threshold for materiality nor a pre-determination of what constitutes materiality in any particular situation, entities must use their judgement to determine this (*Conceptual Framework*, 2018: chapter 2.11).

Judgements around 'materiality' are common; entities must make materiality judgements to determine the level of precision when (i) applying accounting policies in practice (e.g. capitalisation thresholds for property and equipment), (ii) determining what disclosures are most meaningful to users and (iii) determining the level of aggregation of information throughout published financial statements (e.g. portfolios of financial assets subject to expected credit losses). Examples of common areas judgements around materiality must be made include the presentation of financial statements (IAS 1), accounting policies (IAS 8), provisions and contingent assets/liabilities (IAS 37) as indicated below:

IAS 1: **31** An entity need not provide a specific disclosure required by an IAS/IFRS if the information is not material; non-material items need not be included.
IAS 8: Accounting policies and prior errors specified by IFRS need not be applied when the effect of applying them is immaterial (para 8); however, an accounting policy may be considered as significant because of the nature of the entity's operations even if the amounts for current and prior periods are not material (IAS 1: 121)
IAS 37: Only material contingent assets and liabilities need to be disclosed.
Since no uniform threshold for materiality exists neither in the *Conceptual Framework* nor within the relevant standards (e.g.. IAS 1 & IAS 8), each reporting entity must use its judgement to determine what is material..

3. Accrual basis of accounting. Except for the statement of cash flow information, the *Conceptual Framework* and IAS 1: 27 require that an entity prepares its financial statements using the accrual basis of accounting. Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. By its nature, the accrual basis of accounting involves some degree of judgement about future cash flows. All working capital accruals (e.g., unearned revenues, bad debt allowances, income tax expense & inventory valuation adjustments) involve estimates of and judgements about future outcomes. Similarly, longer-cycle accruals such as asset impairment charges, loss provisions, health care and pension costs and liabilities, deferred tax valuation adjustments, bank loan loss provisions, etc., also involve estimates of and judgements about outcomes at more distant future dates (Ball, 2006).

4. Accounting policies. Preparers of financial statements use their judgement to select accounting policies, being the specific rules or principles that apply to the transaction(s), other events (s) or condition(s) in the course of preparing and presenting financial statements. Accounting policies encompass everything, from the recognition/de-recognition and measurement of assets and liabilities, and related income and expense items to presentation and disclosures in financial statements. Where an IFRS is specifically relevant to a transaction, other event or condition, the accounting policy applied to that item is determined by applying that standard (IAS 8: *Accounting Policies, Changes in Accounting Estimates and Errors*).

In the absence of an IFRS that specifically applies to a transaction, other event or condition, preparers of financial statements are entitled to use their judgement in developing and applying an accounting policy that results in information that: (a) is relevant to the economic decision-making needs of users; and (b) is reliable, in that the financial statements: (i) faithfully represent the financial position, financial performance and cash flows of the entity; (ii) reflect the economic substance of transactions, other events and conditions, and not merely its legal form; (iii) are neutral, i.e. free from bias and (iv) are prudent. (IAS 8: 10–11). Preparers of financial statements must use their judgement to select from alternatives/elections allowed in IFRS[2], where available, the best option/alternative that meets the fundamental and enhancing qualitative characteristics of useful financial information criteria (*Conceptual Framework,* chapter 6*)*. An example of this is the disclosure of whether a venturer recognises its interest in a jointly controlled entity using proportionate consolidation or the equity method (IAS 31: *Interests in Joint Ventures*). Some IFRSs specifically require disclosure of particular accounting policies, including choices made by the reporting entity's management between different policies they allow. For example, IAS 16 requires disclosure of the measurement bases used for classes of property, plant and equipment (IAS 1: 119).

5(i). Presentation IAS:1 (paragraphs 10-17) prescribes a set of five financial statements with a requirement that these statements fairly present the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions, in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework*. The

---

[2] IFRS Standards include various accounting policy choices / elections: (a) some of which an entity must apply on a transaction-by-transaction basis; and (b) others which an entity must apply in respect of whole classes of items. Of these accounting policy choices / elections: (a) some must be determined on an irrevocable basis; and (b) others are subject to change based on satisfying the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. A discussion of the identification of the various accounting policy choices / elections available in IFRS and considerations of the bases on which those choices can be exercised and, in some cases, changed ,is outside the scope of this paper.

application of IFRSs, with additional disclosures when necessary, is presumed to result in financial statements that achieve a fair presentation. An entity achieves a fair presentation by compliance with applicable IFRSs. The fair presentation also requires an entity: (i) to select and apply accounting policies in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors,* which sets out a hierarchy of authoritative guidance that an entity considers in the absence of an IFRS that specifically applies to an item; (ii) to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; and (iii) to provide additional disclosures that comply with the specific requirements in specific IFRSs that is sufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance, such as the significantly expanded disclosure requirements in IFRS 15:*Revenue from Contracts with Customers*.

Entities use their judgement regarding the form of presentation, which sub-classifications to present and which information to present on the face of the statements or to disclose in the Notes. A complete set of financial statements are:

i. ***The statement of financial position*** that may classify assets and liabilities as current or non-current, unless the presentation is in order of liquidity, such as obtained in financial institutions, is adjudged to provide more reliable and relevant information.

ii. ***The statement of profit or loss and other comprehensive income*** includes all items of income and expense, presented as either a single statement, with a sub-total for profit or loss or as separate statements of profit or loss and other comprehensive income. Within the profit or loss section expenses may be presented either by their nature (e.g. depreciation) or by function (e.g. cost of sales).

iii. ***The statement of changes in equity*** shows the total comprehensive income for the period; the effects on each component of equity of retrospective application or retrospective re-statement in accordance with IAS 8; and for each component of equity, a reconciliation between the opening and closing balances, disclosing each change separately.

iv. ***The statement of cash flows*** is based on IAS 7: *Statement of Cash Flows* which sets out the presentation requirements about changes in cash and cash equivalents. Cash flows are classified as flowing from/to operating, investing and financing activities. Operating activities are the principal revenue-producing activities of the entity. Operating cash flows are reported using either direct or indirect methods. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. Judgements may be applied in the classification of certain cash flows relating to operating, investing and financing activities.

v. ***The notes*** provide additional information about the amounts in the primary statements. The 'notes' must include information about the accounting policies followed; the judgements that management has made in the process of applying the entity's material accounting policies that have the most significant effect on the amounts recognized in the financial statements; sources of estimation uncertainty; and disclosures on capital and puttable financial instruments classified as equity.

5(ii)Disclosures: IAS 1:122 indicates several judgemental domains, that require disclosure of the judgements on significant issues in applying accounting standards where a different judgement might lead to a materially different accounting treatment. Examples of potential areas where judgements may arise that require disclosure under IAS 1.122 include: (i) revenue recognition, particularly complex cases involving multiple-element arrangements (IFRS 15); (ii) lease classifications (IFRS 16); (iii) de-recognition (or not) of an asset or liability (IFRS 9); (iv) whether an investee is a subsidiary or not (IFRS 9; IFRS 10); (v) whether an acquisition is of a business or group of assets (IFRS 3; IFRS 10); (vi) whether a joint arrangement structured through a separate entity is a joint operation or a joint venture under IFRS 11 *Joint Arrangements*; (vi) which entity is the acquirer in a business combination under IFRS 3 *Business Combinations* (i.e. whether the combination is an acquisition or reverse acquisition); and (vii) determining an appropriate discount rate for pension obligations where there is a range of rates on high-quality corporate bonds or where such rates are not available in the relevant market (IAS 19; IFRS 13).

6. Judgements around Measurements. IFRS mandates the measurement of assets, liabilities and related revenue and expenses at historical cost and/or at current value. The historical cost reflects the price of the transaction or other event that gave rise to the related asset, liability, income or expense. A current value measurement updates the prior-period measure and reflects conditions at the current measurement date. Because of the updating, current values of assets and liabilities reflect changes since the previous measurement date, in estimates of cash flows and other factors reflected in those current values. Measurement bases of current values are three: (i) fair value, (ii) value in use for assets and fulfilment value for liabilities and (iii) current cost. An entity uses its judgement to select the measurement basis/bases that provide the most relevant information that faithfully represents the underlying substance of a transaction and discloses the measurement basis or bases used in the financial statements (e.g. historical cost, fair value, value in use/fulfilment value or current cost). Disclosure of measurement type(s) is necessary for the view of the fact that the basis on which an entity prepares the financial statements significantly affects users' analysis (of financial statements). The *Conceptual Framework* does not preclude the use of different measurement bases for an asset or a liability in the statement of financial position and the related income and expenses in the statement of financial performance. Therefore, in using multiple measurement bases in the financial statements (e.g. when particular classes of assets are revalued), an entity is obliged to indicate the categories of assets and liabilities to which each measurement basis is applied (*Conceptual Framework, 2018:*chapter 6; IAS 1: 118; IFRS 13; Heidhues& Patel, 2009).

7. Judgements around Estimates. Apart from cash in local currency, almost all assets and liability amounts recognised in financial statements today reflect some estimates of the future (Barth, 2006). It can be said, therefore, that financial statements are a collection of financial estimates.

IAS 8 has two definitions for accounting estimates: (i) monetary amounts in financial statements that are subject to measurement uncertainty and (ii) an adjustment of the carrying amount of an asset or liability, or related expense or the amount of the periodic consumption of an asset, resulting from reassessing the present status of expected future benefits and obligations associated with the asset or liability. Judgements around estimations are dealt with under IAS 1:125 wherein it is mandated that a reporting entity discloses estimation judgements in a manner that helps users of financial statements to understand the judgements made about the future and other sources of estimation uncertainty (IAS 1: 129).

Determining the carrying amounts of some assets and liabilities requires estimations of the effects of uncertain future events on those assets and liabilities at the end of the reporting period. For example, in the absence of recently observed market prices, future-oriented estimates are necessary to measure the recoverable amount of classes of property, plant and equipment; the effect of technological obsolescence on inventories, provisions subject to the future outcome of litigation in progress, and long-term employee benefit liabilities such as pension obligations. These estimates involve assumptions about such items as the risk adjustment to cash flows or discount rates, future changes in salaries and future changes in prices affecting other costs (IAS 1:126).

The assumptions and other sources of estimation uncertainty disclosed in accordance with IAS 1:125 relate to the estimates that require management's most difficult, subjective or complex judgements. As the number of variables and assumptions affecting the possible future resolution of the uncertainties increases, those judgements become more subjective and complex, and the potential for a consequential material adjustment to the carrying amounts of assets and liabilities normally increases accordingly.

Regarding accounting estimate changes, IAS 8 (paragraphs 36-37) mandates that if the judgement of a reporting entity is to the effect that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, it is recognised by adjusting the carrying amount(s) of the related asset, liability or equity item(s) in the period of the change.

8. Judgements around Recognition and De-recognition: Chapter 5 of the *Conceptual Framework (2018)* addresses recognition and de-recognition of the elements of financial statements (i.e., an asset or a liability and any related income, expenses or changes in equity). The requirements are that when a reporting entity undertakes a transaction or when some other relevant event occurs, the effect of that transaction or event on the elements of financial statements will need to be recognised or de-recognised in the financial statements if such recognition/de-recognition provides users of financial statements with relevant information and presents a faithful representation of the underlying transaction.

Recognition: (1) If a transaction or other event has created a new asset or liability or added to an existing asset or liability, that effect will be recognised if: (a) sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability; and (b) the new asset or liability or the addition to the existing asset or liability can be

reliably measured in monetary terms. (2) In a transaction involving the provision of services or goods for a net gain, the recognition criteria will be met upon the occurrence of the critical event in the operating cycle at which point there will be sufficient evidence that the gain has occurred and it will be possible to measure that gain with sufficient reliability.

De-recognition: An asset or liability will be wholly or partly de-recognised if: (a) sufficient evidence exists that a transaction or other past event has eliminated all or part of a previously recognised asset or liability; or (b) although the item continues to be an asset or a liability, the criteria for recognition are no longer met.

Entities use professional judgement to implement these requirements. For an asset or liability to be recognised it must also be measured. Most measures must be estimated, requiring the use of professional judgement and a trade-off between providing a more relevant measure that has a high level of estimation uncertainty[3] and a measure (historical cost or current value) that might be less relevant but has lower estimation uncertainty. In limited circumstances, all relevant measures may be subject to high measurement uncertainty, such that the asset or liability should not be recognised. The *Conceptual Framework* (2018) did not provide any detailed guidance, because recognition/de-recognition is a matter of judgement by each entity in assessing the several factors that will depend on the facts and circumstances of each case. It might be that some uncertainties should result in more supplementary information being provided by reporting entities.

Recently, the IASB issued two new standards: (IFRS 9, *Financial Instruments* & IFRS 15, *Revenue from Contracts with Customers*). Both standards are effective for annual periods beginning on or after 1 January 2018. These new standards are likely to significantly affect the financial statements of many issuers given the financial statement line items affected and the prevalence of transactions within their scope. These recent standards have been selected for inclusion in this essay.

9. ***Classification and measurement of financial assets***: IFRS 9: *Financial instruments* specify how an entity should classify and measure financial assets, financial liabilities, and some contracts to buy or sell non-financial items. IFRS 9 requires an entity to recognise a financial asset or a financial liability in its statement of financial position when it becomes a party to the contractual provisions of the instrument.

At initial recognition, an entity measures a financial asset or a financial liability at its fair value plus or minus, in the case of a financial asset or a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability.

3 Chapter 5 of the *Conceptual Framework* provides a high-level overview of how different types of uncertainty (e.g. existence, outcome & measurement uncertainties) could affect the recognition decision

After an entity first recognises a financial asset, an entity subsequently classifies and measures its financial assets based on the entity's business model for managing the asset and the asset's contractual cash flow characteristics, at:

1. ***Amortised cost***—a financial asset is measured at amortised cost if both of the following conditions are met: (i) the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and (ii) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.

2. ***Fair value through other comprehensive income (FVOCI)***—financial assets are classified and measured at fair value through other comprehensive income if they are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

3. ***Fair value through profit or loss (FVTPL)***—any financial assets that are not held in one of the two business models mentioned (in 1 & 2) are measured at fair value through profit or loss.
When and only when, an entity changes its business model for managing financial assets it must reclassify all affected financial assets.

An entity makes extensive judgements in assessing its business model(s) for managing financial assets and assessing contractual cash flow characteristics to determine whether the cash flows are SPPI. In particular, an entity will exercise professional judgement to assess its business model for managing financial assets; that assessment is not determined by a single factor or activity. Rather, the entity must consider all relevant evidence that is available at the date of the assessment. Similarly, assessing whether the contractual cash flows are SPPI is consistent with a basic lending arrangement in which consideration for the time value of money and credit risk are typically the most significant elements of interest[4]. And so, if for example, cash flows vary because of the credit risk, judgement has to be exercised to determine whether these variations are compensation for credit risk or not and whether the assets meet the SPPI criterion (Huian, 2012).

10. Revenue Recognition Judgements: IFRS 15: *Revenue from Contracts with Customers* sets out the principles for revenue recognition and measurement together with related disclosures. The core revenue recognition principle is that an entity will recognise revenue when the control over a product/service is transferred to the client, either over time or at a point in time. The application of this principle depends on the facts and circumstances present in a contract with a customer and requires the exercise of professional judgment (Holzmann & Munter, 2015, Huefner, 2015). To implement the principles in IFRS 15, entities adopt a five-step revenue recognition process : (i) identify the contract with the customer, (ii) identify the performance obligations contained in the

[4] Interest can also include other considerations. such as liquidity risk an administrative costs associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement

contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations, and (v) recognise revenue when each performance obligation is satisfied. In view of the extensive judgements necessary in the revenue recognition process; and also to assist the users of financial statements to understand the amount(s), timing and uncertainty of revenue and cash flows, entities are mandated to disclose additional information about contacts with the various classes of customers and information about the various judgments and changes in those judgments that were made during the reporting period.

In addition, because several issues may exist beyond applying the five-step recognition process, IFRS provides guidance in several areas (e.g., rights of return, licensing intellectual property, principal versus agent considerations, consignment arrangements, non-refundable upfront fees, un-exercised rights, re-purchase agreements, etc) to assist entities to exercise judgements in applying the model.

CONCLUSION

The principles-based nature of the IFRS, with the high levels of flexibility embedded in them, requires accountants to exercise extensive judgement in the development and presentation of financial statements. As can be deduced from the sampled ten domain areas, it should be self-evident that the exercise of professional judgements is the *sine qua non* in the implementation of all IFRSs. Indeed, all principles-based standards mandate or permit the exercise of judgement in the preparation of financial statements. The exercise of professional judgement in implementing PBS is so pervasive that it can be inferred that the ability to exercise professional judgement is not only the key skill for preparers of PBS-based financial statements; it is also the hallmark of accounting professionals.

References

ACIFR (2008) Advisory Committee on Improvements to Financial Reporting to The United States Securities and Exchange Commission https://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf

Agoglia, C., Doupnik, T., &Tsakumis, G. (2011). Principles-based versus rules-based accounting standards: the influence of standard precision and audit committee strength on financial reporting decisions. *The Accounting Review*, 86(3), 747-767

Ajekwe, C, (2021) Impact of Flexibility in Accounting on Financial Reporting, *European Journal of Accounting, Auditing and Finance Research*, 9(3):74-87 https://www.eajournals.org/wp-content/uploads/Impact-of-flexibility-in-accounting-on-financial-reporting.pdf

Ajekwe, C. (2017). Flexibility in Accounting: A Slippery Slope to Fraud? *The International Journal of Business & Management, 5(6) June* http://www.theijbm.com/wp-content/uploads/2017/06/17.-BM1706-049.pdf

Alexander, D.J.A., & Jermakowicz, E.K. (2006). A True and Fair View of the Principles/Rules Debate. *Abacus,* 42 (2), 132-164.

Ball, R. (2016) IFRS – 10 years later, *Accounting and Business Research,* 46:5, 545-571, DOI: 10.1080/00014788.2016.1182710

Ball, R., 2006. International Financial Reporting Standards (IFRS): Pros and Cons for Investors. *Accounting and Business Research* 36, International Accounting Policy Forum, 5–27.

Benston, J.G., Bromwich, M., &Wagenhofer, A. (2006). Principle- Versus Rules-Based Accounting Standards: The FASB's Standard-Setting Strategy. *Abacus*, 42 (2), 165-188.

Beresford, D. R. (1999). It's time to simplify accounting standards. *Journal of Accountancy* 187, 3: 65-67

Bialkowska, E., & Martin, C. (2005). Banking sector and IAS - A matter of judgment https://www.accountancydaily.co/banking-sector-and-ias-matter-judgment

Canadian Institute of Chartered Accountants. (1995). Professional judgement and the auditor. *Research report.* Toronto: CICA

Chand, P., & White, M. (2006). The Influence of Culture on Judgements of Accountants in Fiji. *Australian Accounting Review* 16 (38):82-88..

Collins, D. L., Pasewark, W. R., & Riley, M. E. (2012). Financial reporting outcomes under rules-based and principles-based accounting standards. *Accounting Horizons*, 26(4), 681-705

Cormier D, &Magnan M, 2005. From accounting to forecounting. *Canadian Accounting Perspectives* 4,2: 243- 255

D'Arcy, A. (2000). The degree of determination of national accounting system: an empirical investigation. *Schmalenbach Business Review*, 52, 45-67

Dye, R., &Verrecchia, R., (1995). Discretion vs. uniformity: choices among GAAP. *Accounting Review* 70, 389–415

Grout, P., Jewitt, I., Pong, C., Whittington, G., Dewatripont, M., Laroque, G. (1994), Auditor`s professional judgement: implications for regulation and the law, *Economic Policy,* 9(19):307-351;

Hatherly, D. (1999), The future of auditing: the debate in the UK, *The European Accounting Review,* 2: 51–65

Heidhues, E., & Patel, C. (2009). IFRS and Exercise of Accountants Professional Judgements: Insights and Concerns from a German Perspective (pp 1-47). In A. Cheng (Ed.), *IAAER & ANPCONT (3rd) International Accounting Congress* Sao Paulo: IAAER - International Association for Accounting Education and Research

Herdman KR, 2002. Testimony: Are current financial accounting standards protecting investors? [http://www.sec.gov/news/testimony/021402tsrkh.htm]

Holzmann, O. J., & Munter, P. (2015). Challenges in Achieving Convergence Between U.S. GAAP and IFRS-The Case of the Revenue Recognition Standard. *Journal of Corporate Accounting & Finance, 26(6), 101–106.* doi:10.1002/jcaf.22087

Huefner, R. J. (2015). The impact of new financial reporting standards on revenue management. *Journal of Revenue and Pricing Management, 15(1), 78–81.* doi:10.1057/rpm.2015.45

Huian, M. C. (2012). Accounting for Financial Assets and Financial Liabilities According to IFRS 9. *Annals of the Alexandru Ioan Cuza University - Economics*, 59(1). doi:10.2478/v10316-012-0002-0

International Accounting Standards Board, (2018).*The Conceptual Framework for Financial Reporting* London UK

Ivan, I. (2016), The importance of professional judgement applied in the context of the International Financial Reporting Standards, Audit Financiar, XIV, 10(142)/2016: 1127-1135 http://dx.doi.org/10.20869/AUDITF/2016/142/1127

PriceWaterhouseCoopers (PWC) (2008). Principles-based Accounting Standards https://pwc.blogs.com/corporatereporting/files/principlesbased_accounting_standards.pdf

Schipper, K. (2003). Principles-based accounting standards. *Accounting Horizons*,17(1), 61-72.

Securities and Exchange Commission. (2003). *Study pursuant to Section 108 (d) of the Sarbanes-Oxley Act of 2002 on the adoption by the United States financial reporting system of a principles-based accounting system.* http://www. sec.gov/

Ștefan-Duicu, V, & Ștefan-Duicu, A, (2017). "The Professional Judgement and the IAS/IFRS Referential," *Global Economic Observer, "Nicolae Titulescu" University of Bucharest, Faculty of Economic Sciences; Institute for World Economy of the Romanian Academy*, 5(2): 113-118.. https://ideas.repec.org/a/ntu/ntugeo/vol5-iss2-17-113.html

Sunder, S. (2009). IFRS and the accounting consensus. *Accounting Horizons*, 23(1), 101-111

Wüstemann, J., & Wüstemann, S. (2010). Why Consistency of Accounting Standards Matters: A Contribution to the Rules-Versus-Principles Debate in Financial Reporting, *Abacus*, 46 (1), 1-28