Chapter 2

The conceptual framework of accounting and its relevance to financial reporting

Review questions

2.1 See pages 49 and 50 for two definitions of a conceptual framework: one by the Financial Accounting Standards Board (FASB), the other included in Policy Statement 5 (issued jointly by the Australian Accounting Research Foundation and the Australian Accounting Standards Board).

2.2 The term *general purpose financial statements* refers to financial statements that comply with the conceptual framework, accounting standards and other generally accepted accounting principles and are released by *reporting entities* to satisfy the information demands of a varied cross-section of users. These reports can be contrasted with special purpose financial statements, which are provided to meet the information demands of a particular user or group of users. General purpose financial statements are defined in Australian accounting standards (for example, in AASB 1053 *Application of Tiers of Australian Accounting Standards*) as "those financial statements intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs". This definition is also consistent with the contents of the IASB/AASB Conceptual Framework.

2.3 A reporting entity can be defined as:

> *An entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.*

The above definition is provided in AASB 1053 and is consistent with the definition in the IASB/AASB Conceptual Framework. General purpose financial statements should be prepared when there are users whose information needs have common elements, and those users cannot command the preparation of information to satisfy their individual information needs. If an entity is not deemed to be a 'reporting entity' then it will not be required to produce GPFSs, nor will it necessarily be required to comply with all accounting standards.

Whether an entity is classified as a reporting entity is determined by the extent to which users (of financial information relating to that entity) have the ability to command the preparation of financial statements tailored to their particular information needs. Such a determination depends upon professional judgment. When information relevant to decision making is not otherwise accessible to users who are judged to be dependent upon general purpose financial statements to make and evaluate resource-allocation decisions, the entity is deemed to be a reporting entity. Where dependence is not readily apparent, Statement of Accounting Concept No. 1 (SAC 1) suggests that factors that might indicate a reporting entity include:

- the separation of management from those with an economic interest in the entity (paragraph20)—as the spread of ownership and/or the separation of management and ownership increase, so does the likelihood of an entity being considered to be a reporting entity

- the economic or political importance/influence of the entity to/on other parties (paragraph 21)—as the entity's dominance in the market and/or its potential influence on the welfare of external parties increase, so does the likelihood of an entity being considered to be a reporting entity
- the financial characteristics of the entity (paragraph 22)—as the amount of sales, value of assets, extent of indebtedness, number of customers and number of employees increase, so does the likelihood of an entity being considered a reporting entity.

2.4 The history of the development of a conceptual framework in Australia is that prior to adoption of the IASB Framework in 2005 Australia had developed four statements of accounting concept (SACs). The first SAC was released in 1990, which was a number of years after our first accounting standard was released. Ideally a conceptual framework should be developed prior to the release of accounting standards. Within Australia, as in many other countries, the development of the conceptual framework stagnated and no further statements of accounting concepts were released since the mid 1990s. Issues such as those relating to measurement failed to be addressed. Indeed, measurement questions or issues appeared to represent a stumbling block to the development of conceptual frameworks worldwide. When Australia adopted IFRS in 2005 we also, by necessity, adopted the IASB Conceptual Framework. The IASB and FASB are currently undertaking a joint project to develop a revised conceptual framework of accounting. The first phase of the joint IASB/FASB initiative was completed in September 2010 and the IASB Conceptual Framework was amended. It was renamed to become the *Conceptual Framework for Financial Reporting*. The October 2010 revised version of the *Conceptual Framework* includes the first two chapters that the IASB has published as a result of its first phase of the conceptual framework project, these being:

- Chapter 1 *The objective of financial reporting*
- Chapter 3 *Qualitative characteristics of useful financial information*.

Chapter 2 of the Conceptual Framework, which has not yet been updated, will deal with the reporting entity concept. The IASB published an exposure draft on the reporting entity concept in March 2010. Chapter 4 contains the remaining text of the original IASB *Framework* (1989).

It should also be acknowledged that as of June 2012 the AASB had not made the revised IASB Conceptual Framework available on its website, but rather, still had the older *Framework for the Preparation and Presentation of Financial Statements* shown on its website. In part this was due to the fact that the conceptual framework being developed by the IASB and FASB applies to private 'for-profit' entities whereas the Australian framework will have broader application to not-for-profit entities therefore requiring some modifications to the IASB Conceptual Framework before it is made available within the Australian context. That is, there will be a time lag between when the IASB/FASB complete a component of the Conceptual Framework Project and when it is ultimately included on the AASB website.

Two of our pre-existing Australian statements of accounting concepts—SAC 1 *Definition of the reporting entity* and SAC 2 *Objective of General Purpose Financial Reporting*—were retained after 2005 because the related issues were not addressed in the IASB Framework. However, with the amendments made to the IASB Conceptual Framework in 2010 the contents of the previous SAC 2 were no longer applicable within Australia given that work on defining the objective of general purpose financial reporting—which had been the subject of SAC 2—had been completed by the IASB and FASB and incorporated within the framework released in September 2010. However, as the joint work being undertaken by the IASB and FASB has not yet been completed in relation to definitional issues associated with the 'reporting entity' concept, SAC 1 *Definition of the Reporting Entity* is still applicable within the Australian context.

2.5 Whether or not we need a conceptual framework is a matter of opinion. Also, what is included within a conceptual framework will also be a matter of opinion. For example, we might not all agree on the stated *objectives* of general purpose financial reporting or on the *qualitative characteristics* that financial information should possess.

Ideally we would have had a conceptual framework prior to the development of accounting standards as this may have enabled the development of accounting standards that are consistent with one another. Also, if there is agreement on certain fundamental and key issues then such issues would not need to be debated each time a new accounting standard is being developed. It is a costly process to develop a conceptual framework, and one which will require ongoing work. It should be noted that the development of the conceptual framework within Australia was very slow, with limited outputs during the 1990s and early 2000s. Many of the issues or building blocks shown in Figure 2.1 on page 55 remain to be addressed. From 2005 we adopted the IASB Framework, which replaced SAC 3 and SAC 4. It is generally considered that the IASB Framework is not as robust as the conceptual framework that we previously used within Australia. Ongoing work is being undertaken by the IASB and the FASB to develop a joint conceptual framework to be used internationally and in 2010 amendments were made and a new component of the framework was released.

2.6 The objective of having a conceptual framework would broadly be to make general purpose financial reporting consistent with a given (stated) objective of such reporting. A conceptual framework should also act to ensure that general purpose financial statements are consistent with each other in terms of objectives of reporting, the qualitative characteristics that any related information should possess, key definitions and recognition criteria. A conceptual framework should assist in ensuring that accounting standards are not developed in an *ad hoc* manner. A conceptual framework will also act to make accounting standard setters more accountable for their decisions, as well as making the accounting standard-setting process more economical.

2.7 In considering the matter of the level of expertise expected of financial statement readers, it has generally been accepted that readers are expected to have some proficiency in financial accounting. As a result, accounting standards are developed on this basis. The FASB Conceptual Framework had referred to the 'informed reader'. In the IASB Conceptual Framework, as released in 2010, it is explained that:

> *Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.*

Therefore, financial statements are not compiled for an audience that is not educated to some degree in the workings of accounting - this is an interesting observation given the many hundreds of thousands of financial statements being sent to investors annually, most of whom would have no grounding whatsoever in accounting. Students should be encouraged to consider whether it is reasonable to make this assumption about perceived expertise. If this assumption was not made then what implications would this have for accounting standards and general purpose financial statements? Is there a realistic alternative to making this assumption?

2.8 The IASB Conceptual Framework defines income as:

> *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.*

The Conceptual Framework draws a distinction between 'revenues' and 'gains'. Income consists of *both* revenues and gains. Under the Conceptual Framework, '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. 'Gains' represent other items that meet the definition of income and might, or might not, arise in the course of the ordinary activities of an enterprise. Gains include, for example, those arising on the disposal of non-current assets. Some measure of professional judgment will be involved in determining whether a component of income should be classified as 'revenue' or as a 'gain'. Prior to 2005, within Australia, rather than referring to income we referred to revenue. Revenue was not further subdivided. Students should be encouraged to consider whether it is useful to subdivide income into revenues and gains.

2.9 The fundamental qualitative characteristics identified in the IASB *Conceptual Framework for Financial Reporting* (as released in 2010) are 'relevance' and 'faithful representation'. This represents a departure from the previous IASB *Framework for the Preparation and Presentation of Financial Statements* wherein the primary qualitative characteristics were considered to be 'relevance' and 'reliability'. That is, the 'new' framework in place since 2010 has replaced relevance with faithful representation. In discussing the need for information to be relevant and faithfully represented, paragraph QC17 of the IASB Conceptual Framework states:

> *Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions.*

Relevance is a fundamental qualitative characteristic of financial reporting. Under the IASB Conceptual Framework, information is regarded as *relevant* if it is considered capable of making a difference to a decision being made by users of the financial statements. Specifically, paragraph QC 6 states:

> *Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.*

There are two main aspects to relevance. For information to be relevant it should have both *predictive value* and *confirmatory value (or feedback value)*, the latter referring to information's utility in confirming or correcting earlier expectations.

Closely tied to the notion of *relevance* is the notion of *materiality*. This is embodied in various conceptual framework projects. General purpose financial statements are to include all financial information that satisfies the concepts of relevance and faithful representation to the extent that such information is material.

The other primary qualitative characteristic (other than relevance) is 'faithful representation'. According to the IASB Conceptual Framework, to be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. According to paragraph QC 12 of the IASB Conceptual Framework:

> *To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximise those qualities to the extent possible.*

In terms of the three characteristics of 'complete', neutral' and 'free from error', that together reflect faithful representation, paragraphs QC13, 14, and 15 of the IASB Conceptual Framework state:

QC13 A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description of what the numerical depiction represents (for example, original cost, adjusted cost or fair value).

QC14 A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

QC15 Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

Hence, from the above we should understand that financial information that faithfully represents a particular transaction or event will depict the *economic substance* of the underlying transaction or event, which is not necessarily the same as its *legal form*. Further, faithful representation does not mean total absence of error in the depiction of particular transactions, events or circumstances because the economic phenomena presented in financial statements are often, and necessarily, measured under conditions of uncertainty. Hence, most financial reporting measures involve various estimates and instances of professional judgment. To faithfully represent a transaction or event an estimate must be based on appropriate inputs and each input should reflect the best available information.

2.10 Enhancing qualitative characteristics are complementary to fundamental qualitative characteristics. Enhancing qualitative characteristics distinguish more useful information from less useful information. The enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability. These characteristics enhance the decision-usefulness of financial reporting information that is relevant and faithfully represented. As paragraph QC 4 of the IASB Conceptual Framework states:

> *If financial information is to be useful, it must be relevant and faithfully represents what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.*

2.11 As page 63 of the textbook states, according to the IASB Conceptual Framework, to be useful, financial information must not only represent relevant phenomena, but it must also 'faithfully represent' the phenomena that it purports to represent. According to paragraph QC 12 of the IASB Conceptual Framework:

> *To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximise those qualities to the extent possible.*

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Hence, from the above paragraphs we should understand that financial information that faithfully represents a particular transaction or event will depict the economic substance of the underlying transaction or event, which is not necessarily the same as its legal form. Further, faithful representation does not mean total absence of error in the depiction of particular transactions, events or circumstances because the economic phenomena presented in financial statements are often, and necessarily, measured under conditions of uncertainty. Hence, most financial reporting measures involve various estimates and instances of professional judgment. To faithfully represent a transaction or event an estimate must be based on appropriate inputs and each input should reflect the best available information.

2.12 As page 58 states, within the IASB Framework, the primary users of general purpose financial reports are deemed to be 'investors, lenders and other creditors'. As the IASB Framework (Chapter 1, paragraph OB5) states:

> *Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.*

In the previous conceptual framework released by the IASB the 'public' had been identified as a user of general purpose financial statements. However, in the IASB Conceptual Framework released in 2010, even though a primary group of users are identified, it is proposed that accounting information designed to meet the information needs of investors, creditors and other users will usually also meet the needs of the other user groups identified. As the IASB Conceptual Framework (Chapter 1, paragraph OB10) states:

> *Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.*

In explaining the reasons why the users of financial statements were identified as primarily being investors, lenders and other creditors, the *Basis for Conclusions* that accompanied the release of the IASB Conceptual Framework stated:

> *The reasons why the Board concluded that the primary user group should be the existing and potential investors, lenders and other creditors of a reporting entity are:*
>
> *(a) Existing and potential investors, lenders and other creditors have the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly.*
>
> *(b) The Board's and the FASB's responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors but also potential investors and existing and potential lenders and other creditors.*
>
> *(c) Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.*

Students should be encouraged to discuss whether they agree with the above depiction of users.

In considering the matter of the level of expertise expected of financial statement readers, it has generally been accepted that readers are expected to have some proficiency in financial accounting. As a result, accounting standards are developed on this basis. The IASB Conceptual Framework, (Chapter 3, paragraph Q32) explains that:

> *Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.*

So financial statements are written for an audience that is educated to some degree in the workings of accounting—this is an interesting observation given the many hundreds of thousands of financial statements being sent to investors annually, most of whom would have no grounding whatsoever in accounting. To usefully consider the required qualitative characteristics financial information should possess (for example, relevance and understandability), some assumptions about the abilities of report users are required. It would appear that those responsible for developing conceptual frameworks have accepted that individuals without any expertise in accounting are not the intended audience of reporting entities' financial statements (even though such people may have a considerable amount of their own wealth invested). Again, students should be encouraged to discuss this assumption.

2.13 Directors must comply with accounting standards. Nevertheless, if directors believe that particular accounting standards are not appropriate, they have the option of highlighting this fact and explaining why. Specifically, paragraph 23 of AASB 101 *Presentation of Financials Statements* states:

> *In the extremely rare circumstances in which management concludes that compliance with a requirement in an Australian Accounting Standard would be so misleading that it would conflict with the objective of financial statements set out in the Conceptual Framework, but the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:*
>
> *(a) the title of the Australian Accounting Standard in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the Conceptual Framework; and*
>
> *(b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.*

As we can see from the above, AASB 101 includes a rebuttable presumption that if other entities in similar circumstances comply with the requirement, the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the IASB/AASB *Conceptual Framework*.

2.14 Previously, it was generally accepted that the AASB Conceptual Framework was not mandatory. However, the inclusion of two paragraphs in Accounting Standard AASB 108 *Accounting Policies, Changes in Accounting Estimates, and Errors* has changed this position so that preparers of general purpose financial statements are now required to follow the AASB Framework. Specifically, paragraphs 10 and 11 of AASB 108 state:

10. In the absence of an Australian Accounting Standard that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:

(a) relevant to the economic decision-making needs of users; and

(b) reliable, in that the financial statements:

(i) represent faithfully 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 the legal form;

(iii) are neutral, that is, free from bias;

(iv) are prudent; and

(v) are complete in all material respects.

11. In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements and guidance in Australian Accounting Standards dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework.

Hence, the accounting standard AASB 108, which has the force of law pursuant to the *Corporations Act*, requires management to refer to the IASB/AASB Conceptual Framework where a specific issue is not addressed in a particular accounting standard. That is, in the absence of a specific accounting standard to address an issue, reporting entities must be guided by the IASB/AASB Conceptual Framework.

2.15 Given the central importance of the definition of assets to financial reporting (the definitions of the other elements of accounting are based around the definition of assets), any change to it will conceivably have broad implications for financial reporting. In relation to joint work being undertaken by the FASB and IASB, the FASB and IASB released a *Project Update: Conceptual Framework—Phase B: Elements and Recognition* in 2008. After consulting technical experts, the Boards decided to consider the following working definition of an asset:

An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have.

Whether the above definition replaces the existing definition of assets is something that will be revealed in future years. Certainly, the above definition seems to have some limitations of its own. Again, what we need to appreciate is that given that the definitions of other elements of accounting (equity, income and expenses) rely directly upon the definition of assets, any change to the definition of assets will potentially have very significant impacts on general purpose financial reporting.

In relation to the current thinking on a revised liability definition, the IASB and FASB have suggested the following:

A liability of an entity is a present economic obligation for which the entity is the obligor.

This proposed definition uses a number of key terms, specifically: present, economic obligation and obligor. The IASB and FASB have provided the following definitions of these key terms:

- *Present* means that on the date of the financial statements both the economic obligation exists and the entity is the obligor.
- An *economic obligation* is an unconditional promise or other requirement to provide or forgo economic resources, including through risk protection.
- An entity is the *obligor* if the entity is required to bear the economic obligation and its requirement to bear the economic obligation is enforceable by legal or equivalent means.

Again, as with the proposed change to the definition of assets, the suggested change to the definition of liability could potentially have significant implications for financial reporting if it was ultimately incorporated within the revised conceptual framework. For example, the above definition could act to exclude constructive or equitable obligations that are not 'enforceable by legal or equivalent means'. This would be a major departure from existing practice. Further, and as with the definition of assets, any change to the definition of liabilities will potentially have very significant impacts on the expenses, income and equity of a reporting entity. Again, whether the above proposed definition ultimately becomes part of the revised conceptual framework is a matter for debate.

2.16 Qualitative characteristics as they relate to financial information are those attributes or qualities that financial information should possess if it is to be useful for economic decision making (economic decision making being the primary use of general purpose financial information—according to the Conceptual Framework). The fundamental qualitative characteristics identified in the IASB *Conceptual Framework for Financial Reporting* (as released in 2010) are 'relevance' and 'faithful representation'. Apart from 'fundamental' qualitative characteristics the IASB Conceptual Framework also identifies a number of 'enhancing qualitative characteristics' (which are important, but rank after fundamental qualitative characteristics in order of importance). These 'enhancing qualitative characteristics' are comparability, verifiability, timeliness and understandability.

2.17 We do not need separate recognition criteria for equity. The Conceptual Framework defines equity as 'the residual interest in the assets of the entity after deducting all its liabilities'. The residual interest is a claim or right to the net assets of the reporting entity. As a residual interest, equity ranks after liabilities in terms of a claim against the assets of a reporting entity. Consistent with the definitions of income and expenses, the definition of equity is directly a function of the definitions of assets and liabilities. Given that equity represents a residual interest in the assets of an entity, the amount disclosed as equity will correspond with the difference between the amounts assigned to assets and liabilities. As such, the criteria for the recognition of assets and liabilities, in turn, directly govern the recognition of equity. That is, as equity equals assets minus liabilities, and as we have recognition criteria for assets and liabilities, then equity being the difference does not have to have specific recognition criteria.

2.18 It is preferable to have a well-developed conceptual framework prior to the development of accounting standards because:

- Accounting standards would then be more consistent and logical, because they are developed from an orderly set of concepts. The view is that in the absence of a coherent theory, the development of accounting standards could be somewhat *ad hoc.* As the FASB and IASB (2005, p. 1) state:

  To be principles-based, standards cannot be a collection of conventions but rather must be rooted in fundamental concepts. For standards on various issues to result in coherent financial accounting and reporting, the fundamental concepts need to constitute a framework that is sound, comprehensive, and internally consistent.

- Increased international compatibility of accounting standards should occur, because they are based on a conceptual framework that is similar to that in other jurisdictions (for example, there is much in common between the IASB and FASB Frameworks).
- The AASB and the IASB should be more accountable for their decisions when developing accounting standards, because the thinking behind specific requirements should be more explicit, as should any departures from the concepts that might be included in particular accounting standards.
- Having a conceptual framework should alleviate some of the political pressure that might otherwise be exerted when accounting standards are developed—the conceptual framework could, in a sense, provide a defence against political attack.
- The development of accounting standards and other authoritative pronouncements should be more economical because the concepts developed within the conceptual framework will guide the AASB and the IASB in their decision making.
- Where accounting concepts developed within a conceptual framework cover a particular issue, there might be less need to develop additional accounting standards.

2.19 The elements of financial statements as per the Conceptual Framework are assets, liabilities, expenses, income and equity. See the text on pages 66 to 73 and the IASB/AASB Conceptual Framework for the definitions and recognition criteria of the various elements.

2.20 The recognition of assets, liabilities, income and expenses is dependent upon the following criteria:

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.

The determination of 'probable' is central to the recognition criteria applied to the elements of financial statements. Unfortunately, however, the IASB/AASB Conceptual Framework does not define 'probable'. However, it is generally accepted that probably means 'more likely rather than less likely'.

A transaction or event needs also to be capable of *reliable measurement* before it is recognised for financial reporting purposes. This does not require that there must be certainty in relation to the measurement, because in practice there are many transactions involving estimations that cannot be measured with certainty. For example, in determining the depreciation expense, the useful life of the asset needs to be estimated and this cannot be known with any degree of certainty. As another example, liability provisions are created for liabilities of uncertain timing and/or amount. As paragraph 11 of AASB 137 *Provisions, Contingent Liabilities, and Contingent Assets* states, 'provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing of the amount of the future expenditure required in settlement'. Paragraph 36 of AASB 137 further states that the 'amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period'.

The term 'reliably' means the item can be objectively determined, and the reason behind estimation (if any) can be justified. Therefore, for a transaction or event to be recognised reporting entities have to satisfy the reliable measurement criteria even though they may not be able to be measure the transaction or event with certainty. A measurement is deemed to be *reliable* if it is complete, neutral and free from error.

2.21 Relevance is a fundamental qualitative characteristic of financial reporting. Under the IASB Conceptual Framework, information is regarded as relevant if it is considered capable of making a difference to a decision being made by users of the financial statements. Specifically, paragraph QC 6 states:

> *Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.*

There are two main aspects to relevance. For information to be relevant it should have both predictive value and confirmatory value (or feedback value), the latter referring to information's utility in confirming or correcting earlier expectations.

The other primary qualitative characteristic (other than relevance) is 'faithful representation'. According to the IASB Conceptual Framework, to be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. According to paragraph QC 12 of the IASB Conceptual Framework:

> *To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximise those qualities to the extent possible.*

Ideally, financial information should be both relevant and representationally faithful. However, it is possible for information to be representationally faithful, but not very relevant, or the other way around. Such information would, in this case, not be deemed to be useful. As Paragraph QC 17 of the IASB Conceptual Framework states:

> *Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions.*

There is often a trade-off between relevance and representational faithfulness. For example, the earlier we can obtain the financial performance results of an entity, the more relevant the information will be in assessing that entity's performance. However, to increase the representational faithfulness of the data we might prefer to use financial information that has been the subject of an independent audit (therefore, for example, reducing the likelihood of error). The resultant increase in representational faithfulness, or reliability, will mean that we will not receive the information for perhaps 10 weeks after the financial year end, at which point the information will not be quite as relevant because of its 'age'. Therefore, there can, in practice, be a matter of balancing one against the other. However if the data or information severely lacks one of the characteristics of relevance or faithful representation, then that information should not be provided to financial statement readers.

2.22 Pages 74 to 77 provide some criticisms of conceptual framework projects, such as the IASB/AASB Conceptual Framework. What must be remembered is that different parties will have different views about the need, or otherwise, for conceptual framework projects. Criticisms would include:

- The definitions of the elements of accounting—with the focus on such attributes as 'control'—tend to exclude the consideration of social costs and benefits generated by a reporting entity (arguably, of course, these are very difficult to measure).
- According to the IASB Conceptual Framework, the objective of general purpose financial reporting is to 'provide financial information about the reporting entity that is useful to existing and potential equity investors, lenders and other creditors in making decisions about providing resources to the entity'. Anybody who disagrees with the objective—upon which the Conceptual Framework is based—will then have problems accepting the balance of the Framework. If we were to believe that general purpose financial reports should also focus on providing information about an entity's ability to support various segments of the community or perhaps to support sustainability related initiatives then we would believe the focus of the Framework is too narrow.
- Linked to the above point, the determination of whether an entity is a reporting entity (and therefore required to produce general purpose financial statements) should primarily be dependent upon the existence of users who are dependent on general purpose financial statements for information to be used in making and evaluating economic decisions. By operating in the community, the company has a duty to provide information to people influenced by the organisation's activities, regardless of whether the interested parties are making resource allocation decisions.
- Conceptual frameworks simply reflect a codification of existing practice which tends to describe existing, rather than ideal, practice.
- Conceptual frameworks are used as a means of legitimising the ongoing existence of the accounting profession (that is, they prescribe characteristics such as objectivity).
- The Australian Conceptual Framework was very slow to develop—a criticism that can also be made of other frameworks in place elsewhere, such as the IASB Framework (which has now been adopted within Australia).

- Specific to the IASB Framework (and hence the AASB Framework), we have now replaced 'revenue' with 'income' as an element of financial statements. Income is to be broken down into 'gains' and 'revenue'. It is anticipated that it will not always be clear whether something should be classified as a 'gain' or 'income' and hence it is questionable whether such a dichotomy is of value.

2.23 Materiality is closely tied to the qualitative characteristic of relevance. The IASB/AASB Conceptual Framework states that:

> *Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.*

Assessing materiality is very much a matter of judgment. The definition of materiality provided in the Conceptual Framework is consistent with that provided in AASB 1031 *Materiality*. Generally speaking, if an item of information is not deemed material (which is, of course, a matter of professional judgment), the mode of disclosure or even whether or not it is disclosed at all should not affect the decisions of financial statement readers.

Materiality, by definition, is therefore very economic in nature. Determining whether an item is material is not always a straightforward exercise and it is likely that different financial statement preparers will make different materiality assessments on various items. AASB 1031 provides various quantitative threshold tests that can be used in making an assessment as to whether something is material or not (discussed below). However, as paragraph 15 of AASB 1031 states:

> *Quantitative thresholds used as guidance for determining the materiality of the amount of an item or an aggregate of items shall, of necessity, be drawn at arbitrary levels. Materiality is a matter of professional judgement influenced by the characteristics of the entity and the perceptions as to who are, or are likely to be, the users of the financial report, and their information needs. Materiality judgements can only be properly made by those that have the facts.*

AASB 1031 states that in deciding whether an item or an aggregate of items is material, the nature and amount of the items usually need to be evaluated together. It might be necessary to treat as material an item or an aggregate of items that would not be judged to be material on the basis of the amount involved, because of their nature. An example provided in the standard is where a change in accounting method has taken place that is expected to affect materially the results of subsequent financial years, even though the effect in the current financial year is negligible.

Paragraph 13 of AASB 1031 states that in determining whether the amount of an item or an aggregate of items is material:

(a) *the amount of an item or an aggregate of items relating to the statement of financial position is compared with the more appropriate of:*

  (i) *the recorded amount of equity; and*

  (ii) *the appropriate asset or liability class total; or*

(b) the amount of an item or an aggregate of items relating to the statement of comprehensive income is to be compared with the more appropriate of the:

(i) profit or loss and the appropriate income or expense amount for the current reporting period; and

(ii) average profit or loss and the average of the appropriate income or expense amounts for a number of reporting periods (including the current reporting period); or

(c) the amount of an item or an aggregate of items relating to the statement of cash flows is to be compared with the more appropriate of the:

(i) net cash provided by or used in the operating, investing, financing or other activities as appropriate, for the current reporting period; and

(ii) average net cash provided by or used in the operating, investing, financing or other activities as appropriate, for a number of reporting periods (including the current reporting period).

AASB 1031 provides some arbitrary guidelines for determining the materiality of an item. It is emphasised within AASB 1031 that these are guides only and that the substance of the information needs to be carefully considered. In the absence of evidence to the contrary:

- an amount equal to or greater than 10 per cent of the appropriate base amount is presumed to be material, and
- an item that is equal to or less than 5 per cent of the appropriate base amount is presumed not to be material.

Between 5 and 10 per cent represents a 'grey area' where further professional judgment is required.

2.24 If an item is deemed to be material then it is perceived as likely to influence the economic decisions of the readers of financial statements. This has implications for the recognition, measurement and disclosure of the item. Specifically, if an item is deemed to be material then relevant accounting standards must be applied in respect of the item. Conversely, if an item is not material, then it does not have to be accounted for in accordance with an accounting standard. That is, if an item is not deemed to be material the mode of disclosure should not affect the decisions of financial statement readers. Paragraph 10 of AASB 1031 explains that where an item or an aggregate of items is not material, application of the materiality notion does not mean that those items would not be recognised, measured or disclosed. It means, rather, that the entity would not be required to recognise, measure or disclose those items in accordance with the requirements of an accounting standard. It should be noted that accounting standards currently being issued by the AASB have a materiality provision that holds that if the application, or non-application, of a standard does not lead to information deemed to be of a material nature, that accounting standard need not be followed. For example, the Application section of AASB 107 *Statement of Cash Flows* provides: 'The requirements specified in this Standard apply to financial statements where information resulting from their application is material, in accordance with AASB 1031 *Materiality*'.

Challenging questions

2.25 Before the early 1990s, the directors of a company could elect not to comply with an accounting standard on the grounds that applying the particular standard would cause the accounts not to present a true and fair view. This was referred to as the 'true and fair override'. The perspective taken was that in some isolated cases certain accounting standards might not be appropriate for a particular entity and application of the standards might actually make the financial statements misleading. However, this view was abandoned some years later, and the corporations law was amended and the override withdrawn such that Section 296 of the *Corporations Act* requires that financial statements for a financial year must comply with accounting standards. Directors are therefore required to comply with applicable accounting standards. If, in their view, compliance does not generate a *true and fair view*, additional information should be presented in the notes to the financial statements. That is, if directors believe that particular accounting standards are not appropriate, they have the option of highlighting this fact and explaining why. Specifically, paragraph 23 of AASB 101 *Presentation of Financial Statements* states:

> *In the extremely rare circumstances in which management concludes that compliance with a requirement in an Australian Accounting Standard would be so misleading that it would conflict with the objective of financial statements set out in the Conceptual Framework, but the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:*
>
> *(a) the title of the Australian Accounting Standard in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the Framework; and*
>
> *(b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.*

Numerous writers have argued that as the true and fair view requirement is not clearly defined, directors could invoke the 'true and fair override' to justify not complying with particular accounting standards. Without a clear definition of 'true and fair', it is difficult for ASIC to take action on the basis that the departure did not enhance the truth and fairness of the accounts.

2.26 According to the Conceptual Framework, an item is material if:

> *omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.*

Materiality is determined on the basis of professional judgment, although AASB 1031 does provide some quantitative thresholds that can be used as the basis for determining whether an item is material. Paragraph 13 of AASB 1031 states that in determining whether the amount of an item, or an aggregate of items, is material:

(a) the amount of an item or an aggregate of items relating to the statement of financial position is compared with the more appropriate of:

(i) the recorded amount of equity; and

(ii) the appropriate asset or liability class total; or

(b) the amount of an item or an aggregate of items relating to the statement of comprehensive income is to be compared with the more appropriate of the:

(i)profit or loss and the appropriate income or expense amount for the current reporting period; and

(ii)average profit or loss and the average of the appropriate income or expense amounts for a number of reporting periods (including the current reporting period); or

(c) the amount of an item or an aggregate of items relating to the statement of cash flows is to be compared with the more appropriate of the:

(i)net cash provided by or used in the operating, investing, financing or other activities as appropriate, for the current reporting period; and

(ii)average net cash provided by or used in the operating, investing, financing or other activities as appropriate, for a number of reporting periods (including the current reporting period).

The standard provides some arbitrary guidelines for determining the materiality of an item. It is emphasised within AASB 1031 that these are guides only and that the substance of the information needs to be carefully considered. In the absence of evidence to the contrary:

- an amount equal to or greater than 10 per cent of the appropriate base amount is presumed to be material, and
- an item that is equal to or less than 5 per cent of the appropriate base amount is presumed not to be material.

Between 5 and 10 per cent represents a 'grey area' where further professional judgment is required.

2.27 In answering this question we must consider the definitions of liabilities and equity provided in the Conceptual Framework. In terms of the contents of the Conceptual Framework, if the loan is repayable on demand then the entire amount would be recorded as a liability. If, by contrast, the intention is to make the loan available indefinitely and the repayment is not deemed to be probable then the advance of funds might be considered to be more in the nature of a contribution, and as such, the 'loan' would be considered to be equity. However, whilst the above treatment is consistent with the Conceptual Framework, accounting standards that specifically deal with a particular issue will tend to override the Conceptual Framework. Whilst not covered in this chapter, AASB 9 *Financial Instruments* would tend to classify the above item as a financial liability.

The classification of an item as debt or equity in turn has implications for any associated distribution. If an item is deemed to be a liability then associated payments (other than the repayment) will be deemed to be of the nature of an interest expense. Conversely, if an item is deemed to be equity, then any distributions would be of the nature of a distribution, such as dividends.

2.28 Reporting entities are expected to release general purpose financial statements. Reporting entities can be defined as (this definition came from AASB 1053 *Application of Tiers of Australian Accounting Standards*):

> *an entity in respect of which it is reasonable to expect the existence of users who rely on the entity's general purpose financial statements for information that will be useful to them for making and evaluating decisions about the allocation of resources. A reporting entity can be a single entity or a group comprising a parent and all of its subsidiaries.*

SAC 1 suggests that factors that might indicate a reporting entity include:

- the separation of management from those with an economic interest in the entity (paragraph 20)—as the spread of ownership and/or the separation of management and ownership increase, so does the likelihood of an entity being considered to be a reporting entity
- the economic or political importance/influence of the entity to/on other parties (paragraph 21)—as the entity's dominance in the market and/or its potential influence on the welfare of external parties increase, so does the likelihood of an entity being considered to be a reporting entity
- the financial characteristics of the entity (paragraph 22)—as the amount of sales, value of assets, extent of indebtedness, number of customers and number of employees increase, so does the likelihood of an entity being considered to be a reporting entity.

Given the total gross assets ($4 million) and total revenue ($11 million) it could be argued that relative to many other organisations, such an organisation would not have economic or political influence and as such is unlikely to be a reporting entity. However, the organisation does have 54 full-time employees who are not shareholders and therefore might not have access to information about the financial position and performance of the organisation. On balance, this entity would probably not be considered to be a reporting entity, and hence would not need to release general purpose financial statements (that is, financial statements that comply with accounting standards and conceptual framework requirements).

Whilst the reporting entity concept is based on professional judgment, and perceptions about user needs, the *Corporations Act* provides a different approach to reporting. The *Corporations Act* utilises a classification based on small versus large proprietary companies. Small proprietary companies would typically not be considered to be reporting entities, as it is assumed that most people who require financial information about such an entity will be in a position to specifically demand it. *The Corporations Act,* as opposed to the conceptual framework, has more objective criteria for determining when a company is required to provide financial statements that comply with accounting standards. These criteria, which are set out in the *Corporations Act*, relate to measures such as gross revenue, dollar value of assets and number of employees. Specifically, within the *Corporations Act* a company is deemed by s. 45A(3) to be a large proprietary company, and therefore subject to greater disclosure requirements than 'small proprietary companies' if it meets two or more of the following tests:

- Gross operating revenue for the financial year of $25 000 000 or more.
- Gross assets at the end of the financial year of $12 500 000 or more.
- Full-time-equivalent employees numbering 50 or more.

Unless specific conditions exist, as provided in s. 292(2) of the *Corporations Act*, small proprietary companies do not have to prepare general purpose financial reports. Ripslash Ltd meets two of the above tests and therefore would be deemed to be a large proprietary company and therefore would be subject to relatively extensive disclosure requirements.

2.29 The Conceptual Framework defines an asset as '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'. This definition identifies three key characteristics:

1. There must be a future economic benefit.
2. The reporting entity must control the future economic benefits.
3. The transaction or other event giving rise to the reporting entity's control over the future economic benefits must have occurred.

As indicated in the above definition of an asset, a resource must be controlled before it can be considered to be an 'asset'. It is generally accepted that individuals cannot be 'controlled' and this in itself would preclude employees from being recognised as assets of the entity for financial reporting purposes.

In addition to defining an asset, we also need to consider when we should recognise the existence of an asset. The Conceptual Framework specifically addresses the recognition of assets, and provides that:

> *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.*

Arguably, it would be very difficult to measure the future economic benefits an individual would be expected to generate. Hence, apart from issues associated with 'control', 'measurability problems' would also tend to preclude the recognition of employees as assets.

2.30 The argument is that the development of a conceptual framework is an important strategy to legitimise the ongoing operations of a profession. It is not only useful for assisting members of the profession, but also for giving a profession an appearance of professionalism, objectivity, and so on. There is a view that if a profession specifically states in its own literature that it supports qualitative characteristics such as 'objectivity' and 'freedom from bias' then this will have positive impacts on its own image. It is also argued that if the accounting profession promotes the view that financial statements can be objective and free from bias then the public will believe that financial statements produced by accountants provide some form of 'true' picture about the financial performance and position of an organisation—that somehow there is some form of objective reality which accountants are privy to. Such a view ignores the great deal of professional judgment required, and the selective reporting inherent, in financial accounting.

Hines also argues that if accountants stress that performance indicators such as accounting profits are important then the community will also consider that profits, rather than other non-financial aspects of performance, are most important. If accountants were to embrace other forms of performance indicators, including those that relate to the environment and to social factors, then this may conceivably broaden people's expectations about organisational performance. Further, by emphasising what gets recorded and measured, accountants also, it is argued, control what factors the community tends to focus upon. For example, in emphasising profits (and therefore expenses and revenues), if an organisation dismisses a large part of its workforce as a cost-saving exercise then the positive impacts on profits will be emphasised, whereas the unrecorded social costs of the unemployed workers will tend to be ignored.

The perspective provided by Hines is possibly somewhat critical (or sceptical) but does provide the view that the output of a particular profession can be used as a strategy to determine how that profession is viewed by others. Other issues that students might like to consider would include: whether they actually agree or disagree with Hines' perspectives about conceptual frameworks; reasons why a profession would want to 'self regulate' (Hines argues that the release of conceptual frameworks may reduce the likelihood of government intervention); whether the accounting profession can really influence what aspects of performance society thinks is important; and whether they think 'objectivity' and 'professionalism' go hand-in-hand.

2.31 According to SAC 1, general purpose financial statements should be prepared by all *reporting entities*. 'General purpose financial statements' are reports that comply with statements of accounting concepts and accounting standards. Paragraph 6 of SAC 1 further defines them as reports:

> *intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs.*

Further, paragraph 8 of SAC 1 states that 'general purpose financial statements' should be prepared when there are users:

> *whose information needs have common elements, and those users cannot command the preparation of information to satisfy their individual information needs.*

If an entity is not deemed to be a 'reporting entity' then it will not be required to produce GPFSs; that is, it will not necessarily be required to comply with accounting standards. The determination of whether users are dependent upon GPFSs for the purposes of making and evaluating resource allocation decisions (that is, whether an entity is a reporting entity) requires professional judgment. Where dependence is not readily apparent, SAC 1 suggests factors that may indicate whether the entity is a 'reporting entity'. These factors are:

- the separation of management from those with an economic interest in the entity (paragraph 20)
- the economic or political importance/influence of the entity to/on other parties (paragraph 21)
- the financial characteristics of the entity (paragraph 22).

(a) ABC Pty Ltd is a small proprietary company with two shareholders. In this case, management is not separated from economic interest as Mr and Mrs ABC are involved in the day-to-day operations. The only 'user' appears to be The Bank, which receives management accounts and budgeted cash flow information. Providing The Bank does not advise that it is dependent upon GPFSs, and ABC Pty Ltd has no economic or political influence, ABC Pty Ltd does not appear to be a reporting entity.

(b) F Pty Ltd exhibits some characteristics of being a non-reporting entity. There are few shareholders and there appears to only be one banker who receives accounts. If the bank's borrowing agreement requires GPFSs then whilst the company may not be a reporting entity, it will have to produce GPFSs.

If the bank does not require GPFSs then consideration needs to be given to the fact that 200 staff are employed and it is one of only two companies involved in widget making in Australia. Does it have economic or political influence?

If widgets are significant to the Australian economy then it may be considered to be a reporting entity. If they are not, it may not be (much judgment!). Are the suppliers also users of the financial statements? Are the 200 employees users of the financial statements?

Providing the business is not significant to the economy, and that the creditors do not rely on the financial statements then, more than likely, the company is not a reporting entity.

(c) In deciding whether E Trust is a reporting entity there would be two factors to consider. The maximum number of members is 30 and quarterly reports are produced disclosing the market value of the trust and each member's entitlement.

There is no information given about the trust's borrowing. In the absence of any major borrowings, it would appear that any 'users' are receiving sufficient and timely information without the need to rely on GPFSs.

Although there are 30 members, and hence a separation of management from economic interest, this fact alone does not automatically mean it is a reporting entity. E Trust would probably not be construed to be a reporting entity.

2.32 This question should stimulate good debate. Students should provide arguments to support or oppose global uniformity in accounting standards and conceptual frameworks.

Arguments in support of global uniformity would include:

- support international transfer of capital
- provide an accounting framework for countries that do not have the expertise or wealth to develop their own accounting framework
- reduce accounting costs for multinational companies and companies seeking to be listed on foreign stock exchanges
- reduce duplication of work being undertaken by standard setters throughout the world
- enable the transfer of accounting staff between countries
- allow comparison of results being generated by organisations in different countries.

Arguments in opposition to global uniformity would include:

- There are cultural, religious, political and historical differences that have been shown by researchers to explain why people in different countries demand different types of information. Globalisation ignores such differences.
- Globally, there are variations in business laws, criminal laws, and so forth. Such international variations in laws will be a result of differences in history, cultures, religions, and so forth. While we are apparently prepared to accept international differences in various laws, groups such as the IASB expect there to be global uniformity in regulations relating to accounting disclosure—that is, uniformity in accounting standards. Does this make sense?

- Centralising the development of accounting standards with a limited number of members meeting in one location means that many local needs may be ignored.

3.33 The fundamental qualitative characteristics identified in the IASB *Conceptual Framework for Financial Reporting* (as released in 2010) are 'relevance' and 'faithful representation'. Apart from the 'fundamental' qualitative characteristics the IASB Conceptual Framework also identifies a number of 'enhancing qualitative characteristics' (which are important, but rank after fundamental qualitative characteristics in order of importance). These 'enhancing qualitative characteristics' are comparability, verifiability, timeliness and understandability.

From the article it would appear that the major objections to current reporting practices pursuant to IFRS relate to the *relevance* of the information being generated (a fundamental qualitative characteristic) and the *understandability* of the information (which is an enhancing qualitative characteristic). The quoted people seem to be of the view that information being provided in reports prepared in accordance with IFRS is irrelevant and/or not understandable by investors, fund managers and investment analysts.

In terms of the objective of general purpose financial reporting, paragraph OB2 states:

> *The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.*

Looking at the comments in the extract from the article it would appear that the people providing an opinion do not believe the information being provided within annual reports satisfies the objective of general purpose financial reporting—and that's why they believe the reports are not being read.

Students should be encouraged to discuss if they believe there are merits in the arguments being provided in the article extract.