

Chapter 2

A CONCEPTUAL FRAMEWORK: SCOPE, REPORTING ENTITY AND THE OBJECTIVE OF FINANCIAL REPORTING

LEARNING OBJECTIVES

After studying this chapter you should be able to:

- 1 describe the background to the development of the conceptual framework;
- 2 understand the reasons for developing a conceptual framework;
- 3 describe the structure of the Australian conceptual framework;
- 4 define general purpose financial reporting and distinguish between general purpose financial statements and special purpose financial statements;
- 5 identify the users of general purpose financial statements;
- 6 understand the scope of financial reporting;
- 7 identify reporting entities; and
- 8 define the objective of general purpose financial reporting.

QUESTIONS

- 1 There are eight levels in the conceptual framework. Seven relate to standard setting, and one relates to standards regulation. The seven standard-setting levels of the framework are:
 - i border of discipline/authority;
 - ii subject;
 - iii objective;
 - iv fundamentals;
 - v operational;

- vi display; and
- vii standard-setting policy.

These are discussed in the appendix to *Policy Statement PS5* 'The Nature and Purpose of Statements of Accounting Concepts'.

- 2 General purpose financial statements are designed to meet the common information needs of the users of those statements. There are several potential groups of users of general purpose financial statements, each having different interests and requiring different information. General purpose financial statements ignore the specific information needs of particular groups of users. Instead, the statements attempt to provide information that is of some use to all potential user groups.
- 3 General purpose financial statements are designed to meet the common needs of the users of those financial statements, whereas special purpose financial statements are designed to meet the needs of the users who are requesting those financial statements. Thus, the financial statements accompanying a company's annual report are general purpose financial statements, while financial statements prepared for taxation purposes would be special purpose financial statements.
- 4 Rather than the financial statements being designed to be 'general purpose' financial statements, an alternative approach is to prepare financial statements to meet the needs of the most important, most influential, or dominant group of users. For companies listed on a stock exchange or securities exchange, shareholders and potential shareholders would probably be the most important group of users. If this approach were adopted, then the selected group would be well served by the financial statements, but other groups would have to make do with information prepared to meet the needs of the selected group. This approach has been advocated, although there is more support for the view that the financial statements should be general purpose statements.
- 5 In this question, the users are deemed to be *external* to the entity, which means that general purpose financial statements are not designed to meet the specific information needs of the managers or governing body of the entity. The users are also deemed to be those who cannot prescribe the information they want from an entity. This suggests that general purpose financial statements are prepared for users unable to command information specific to their needs. Users such as small shareholders and small creditors must rely on general purpose reports, as generally they are not sufficiently influential to enforce demands for the information they need. Other users, such as major shareholders, trade unions, governments, institutional investors, etc., may be able to use their influence to obtain special purpose statements specifically designed to meet their financial information needs.

- 6 General purpose financial reports are designed to meet the common information needs of all user groups. According to Barton (cited in the text), these common needs are for information on:
- (a) cash position and cash flows;
 - (b) the financing of operations and on funds flows;
 - (c) the earning power of the entity;
 - (d) the financial position of the entity; and
 - (e) the financial risk incurred in investing funds in the entity.
- 7 There is evidence to suggest that accounting standard setters do not expect financial statements to be prepared that meet the information needs of users with only a limited knowledge and understanding of financial matters. In the US, the Financial Accounting Standards Board (FASB) has adopted the view that financial information should be 'comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence'. The FASB's attitude to 'financially illiterate' statement users is that they should either acquire the necessary skills or hire experts to help them. If they do not adopt either of these alternatives, then they must suffer the consequences of ignorance.

In considering this matter, it should be remembered that the definition of general purpose financial reporting specifies 'users who generally cannot prescribe the information they want from an organisation'. The assumed users are, therefore, small creditors, small shareholders, small investors, small customers, small suppliers and so on who individually have little bargaining power or influence. It seems reasonable to assume that a significant number and perhaps a majority of these users will have a 'limited ability' to interpret financial information. If it is correct that many users of financial statements are financially illiterate, then it makes little sense to provide information which assumes that they have a 'reasonable understanding of business and economic activity'.

It is apparent that the Australian standard-setting bodies have agreed with the FASB and assume that statement users are financially literate. This was first made explicit in *AAS5 'Materiality in Financial Statements'*, which was issued in 1974. Paragraph 6 stated that 'A necessary assumption ... is that users will understand the information given in financial statements'. This has been confirmed by the AASB in the 'Framework for the Preparation and Presentation of Financial Statements'. In explaining the characteristic of 'understandability', paragraph 25 notes that:

... users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.

The attitude of the Australian standard-setting bodies to financially illiterate investors is supported by the efficient market hypothesis, which states that all publicly available information is fully reflected in the market prices of securities and that stock markets

react instantaneously and without bias to new information. This market efficiency is due to the actions of well-informed professionals who mainly work for institutional investors. However, there is evidence that management feels some responsibility to the financially illiterate investor. Many companies include *highlights statements* or *financial summaries* in their annual reports. These statements contain management's selection of the most important data from the financial statements and, in many cases, financial ratios are calculated. The preparation of highlights statements presumably results from a managerial belief either that many shareholders cannot understand the financial statements, or that they are unwilling to make the effort to understand them.

- 8 (a) The elements of financial statements in the Australian conceptual framework are the fundamental elements of the financial statements and comprise assets, liabilities, equity, income and expenses. The 'Framework for the Preparation and Presentation of Financial Statements' establishes the definitions of the elements and specifies criteria for their recognition in financial statements.
- (b) The fundamentals of the conceptual framework are the qualitative characteristics of financial information and the elements of financial statements.
- (c) The qualitative characteristics of financial information are those attributes that financial information should have if it is to serve the objective of general purpose financial reporting, which is to provide information useful to users for decision making.
- (d) 'Recognised' means reported on, or incorporated in amounts reported on, the face of the financial statements of the entity. Thus, reporting of information about assets, liabilities, equity, income and expenses in financial statements may be by way of recognition and/or by disclosure in notes in the financial statements. However, inclusion of the effect of a transaction or event only in notes to the financial statements does not constitute recognition.
- 9 The Australian Accounting Standards Board (AASB) has adopted the International Accounting Standards Board (IASB) conceptual framework which is set out in 'Framework for the Preparation and Presentation of Financial Statements'. As a result, *SAC3* 'Qualitative Characteristics of Financial Information' and *SAC4* 'Elements of Financial Statements' have been withdrawn. However, *SAC1* 'Definition of the Reporting Entity' and *SAC2* 'Objective of General Purpose Financial Reporting' have been retained because these issues are not dealt with adequately in the IASB document. In 2010, the IASB updated its conceptual framework in *Conceptual Framework for Financial Reporting 2010* (Framework 2010). The AASB has yet to adopt Framework 2010. However, it is expected to do so in 2013.
- 10 The Australian Accounting Standards Board (AASB) is obliged to adopt the International Accounting Standards Board conceptual framework, which is developed for businesses. The AASB has decided, therefore, to have a two-part conceptual framework;

one for the business sector which will follow Framework 2010 and the other for the public sector which, for the time being, will be the present conceptual framework.

- 11** A reporting entity is an entity that has users dependent on general purpose financial statements for information that is useful to them for making and evaluating decisions about the allocation of scarce resources.

Users dependent on general purpose financial statements do not have the power/authority to command the information they require for decision-making purposes.

- 12** The factors identified in *SACI* that might assist managers in determining whether an entity is a reporting entity are:

- (a) separation of management from economic interest (para. 20);
- (b) economic or political importance/influence (para. 21); and
- (c) financial characteristics (para. 22).

SACI emphasises that these factors are only provided for the guidance of managers and the main factor to consider is whether there are users dependent on general purpose financial statements for information.

- 13** Two approaches to resolving the differential reporting issue are:

- (a) the use of the reporting entity concept; and
- (b) the use of an arbitrary benchmark, such as the size of an entity, to determine its reporting requirements.

Students may mount reasons for supporting each of these approaches. The arguments that may be employed in reaching a decision include:

- (a) the reporting entity concept is not arbitrary as is a benchmark, such as size;
- (b) it is a conceptually defensible approach;
- (c) the reporting entity concept requires the application of professional skill and judgement, which is likely to make the choice more subjective;
- (d) the use of a size criterion, for example, is objective and simple to interpret.

- 14** The definition of a reporting entity and the factors identified in Question 11 can be used to identify whether the entities in (a), (b) and (c) are reporting entities. Note that in each case the decision as to whether the entity is a reporting entity could be argued either way. This solution only outlines the most likely decision.

- (a)** Zippo should be classified as a reporting entity. Assuming that the employees are given the information they need, the only separation of economic interest from control that needs to be considered is that in relation to the creditors. Since the amount owed to each creditor is relatively small and there is an ability to switch suppliers at will, it would be reasonable to expect that individual creditors would not be able to command the preparation of financial statements tailored to meet, specifically, their information needs. Accordingly, Zippo should be classified as a reporting entity.

- (b) X should not be classified as a reporting entity. Individual members of the company will have the power to command the preparation of financial statements tailored to meet their specific information needs. It is also likely that the supplier and the employees will be able to obtain the information they need for decision-making purposes. Although there is a separation of economic interest and control in that members of the banking syndicate are not involved in day-to-day management, nevertheless, the relationship of the syndicate members with the company is probably such that they would be able to command the preparation of special purpose financial statements tailored to meet their specific information needs.
- (c) LMN should be classified as a reporting entity. The three shareholders/directors have access to the information they need and the bank can presumably demand the preparation of statements to meet its information needs. However, in the case of employees, there is likely to be a separation of economic interest and control. Individual employees are unlikely to be able to command the preparation of financial statements tailored to meet their specific information needs.

15 Zema Pty Ltd

The issue is whether Zema has users dependent on general purpose financial statements for information for decision-making purposes. The possible users of Zema's financial statements identified in the question are: the directors, family members, employees, the bank or banks and the suppliers. In each of these cases it could be argued that the users have access to the information they need for decision making – that is, they are not dependent on general purpose financial statements for their information needs. In that case, the entity is not a reporting entity.

16 Alpha Chemicals Pty Ltd

In answering this question, it is necessary to identify whether there are users dependent on general purpose financial statements for information to meet their decision-making needs. The users identified in the question are as follows:

- 1 five shareholders, each of whom is involved in the company's day-to-day operations;
- 2 100 employees;
- 3 customers, mainly in Victoria and South Australia; and
- 4 a major creditor in the form of a syndicate of banks.

The five shareholders and the major creditors are not dependent users. However, the 100 employees and the customers are unlikely to be able to demand the financial information they need for decision-making purposes. As a result, they are likely to be dependent users. If this is the case, Alpha Chemicals Pty Ltd is a reporting entity.

- 17 (a) The approach adopted in *SACI* is to define a reporting entity and provide a basis for identifying those entities that are reporting entities. In *SACI* individual reporting entities are identified by reference to the existence of users who are dependent on

general purpose financial statements for information for making and evaluating resource allocation decisions.

- (b) The *Corporations Act 2001* applies to listed companies and other disclosing entities, rather than reporting entities. In other words, it specifies the entities to which its requirements apply. As a result, entities required to prepare general purpose financial statements are identified by reference to legislative requirements rather than conceptually by reference to *SAC1*.
- (c) The answer to this question will depend on whether a conceptual or legislative route is preferred by students. Some reasons for supporting one approach rather than the other were identified in the answer to Question 12.

- 18 *Statement of Accounting Concepts SAC2* 'Objective of General Purpose Financial Reporting' was issued in August 1990. Paragraph 7 of *SAC2* states that 'General purpose financial reporting focuses on providing information to meet the common information needs of users who are unable to command the preparation of reports tailored to their particular information needs. These users must rely on the information communicated to them by the reporting entity'. Paragraph 26 elaborates as follows '... the objective of general purpose financial reporting is to provide information to users that is useful for making and evaluating decisions about the allocation of scarce resources'.

Thus, *SAC2* explicitly recognises a decision-usefulness objective for financial reporting. Financial statements should therefore be designed to provide users with information 'that is useful for making and evaluating decisions on the allocation of scarce resources'.

- 19 In the Australian context there are two documents on the objective of general purpose financial reporting; one for the 'for-profit' sector that is dealt with in Chapter 1 of Framework 2010 and the other for the 'not-for-profit' (NFP) sector that is dealt with in *SAC2* 'Objective of General Purpose Financial Reporting'. This has resulted from a decision by the Australian Accounting Standards Board to present the conceptual framework developed by the International Accounting Standards Board for the 'for-profit' sector separately from the conceptual framework for the NFP sector.

Both the documents adopt similar objectives and while there are differences in the wording in the two documents there are no substantive differences between them.

- 20 The choice of 'decision-usefulness' as the objective for financial reporting is a relatively recent phenomenon. Many accountants believe that it cannot be achieved with a measurement system that is primarily designed for stewardship or accountability purposes. They believe that the existing historical-cost measurement basis should be abandoned and replaced by a measurement basis specifically designed to meet the decision-usefulness objective.

However, the conceptual framework has been developed by the accounting standard setters to be neutral with respect to measurement. An accounting theory monograph on

measurement was issued in December 1998, although a concepts statement on measurement was not prepared subsequently by the AASB. Note, however, that consistent with the Financial Reporting Council's decision to adopt International Financial Reporting Standards, the AASB has agreed to adopt the IASB's conceptual framework. The AASB's decision means that further work on the Australian conceptual framework is unlikely.

21 In *SAC2*, the objective of accountability is implicit in the decision-usefulness objective. Accountability is defined in *SAC2* as 'the responsibility to provide information to enable users to make informed judgements about the performance, financing and investing, and compliance of the reporting entity' (para. 5). Paragraph 44 of *SAC2* requires that managements and governing bodies present general purpose financial statements in a way that assists them in discharging their accountability. Therefore, although the objective in *SAC2* emphasises decision-usefulness, this is not incompatible with a need for accountability.

22 The arguments presented in the answer to Question 7 could also be applied in answer to this question.

23 There is evidence that management feels some responsibility to investors who are not financially literate. Many companies include *highlights statements* or *financial summaries* in their published reports. These statements contain management's selection of the most important data from the financial statements and, in many cases, financial ratios are calculated. The preparation of highlights statements presumably results from management's belief that either many shareholders cannot understand the formal reports, or that they are unwilling to make the effort to understand them.

While these attempts to look after the interests of the financially illiterate are laudable, there are some risks associated with highlights statements. The information for inclusion is chosen by management, therefore there is a risk of conscious or unconscious bias. Management may choose only the most favourable items or ratios for inclusion in the highlights statement. Even if the selection is unbiased, investors who are not financially literate may reach unwarranted conclusions on the basis of the incomplete data included in a highlights statement.

24 The information to be included in general purpose financial statements should provide assistance in the decision-making process. In other words, it should be *relevant information*. An obvious way to identify relevant information is to ask the users what they want. There are two difficulties with this approach.

(a) In answering a question about the information they would like, many users of financial statements are constrained by their experiences. Their decision-making processes are geared to the information already available and they may not see advantages in other information that could be provided. They may not appreciate the

usefulness of information that they have never seen before. On the other hand, some users of financial statements may request information that could not feasibly be provided. The requested information could be unavailable, too costly to prepare or too unreliable to assist in decisions.

- (b) The decision-making process is not the same for all decision makers. Two people making the same decision may place most reliance on different information and process it in different ways. Different people who use financial statements may want completely different information to make the same decision. A survey of users of general purpose financial statements to determine users' information needs may not produce a clear consensus.

- 25 *SAC2* proposes that the major user groups need information about performance, financial position, financing and investing, and compliance (paras 28–40). To assess performance, users would need to know income, expenses, assets and liabilities. To assess financial position, *SAC2* suggests that report users need to know about the entity's control over resources, financial structure, solvency and capacity for adaptation. To assess financing and investing, *SAC2* recommends the provision of a statement of sources and applications of funds. Information to assess compliance entails 'disclosure of the nature and probable financial effect of any non-compliance by the reporting entity with externally imposed requirements that has occurred and that is relevant to assessments of the reporting entity's performance, financial position, or financing and investing' (para. 40).

These needs will generally be provided by conventional financial statements. However, students could explore ways in which these reports could be improved.

- 26 (a) The objective of general purpose financial reporting in *SAC2* is to provide information to users for making decisions about the allocation of scarce resources. Users therefore need information about performance, financial position, financing and investing and compliance. The information necessary for an assessment of these attributes is provided in paragraphs 28–40 of *SAC2*. See the answer to Question 23.
- (b) The objective of general purpose financial reporting is meant to provide a focus for the accounting standard setters. They know that when setting accounting standards they should only be requiring the provision of information that is useful to users for making decisions about the allocation of scarce resources. In this sense, therefore, Karen is correct in saying that the objective provides a starting point for the improvement of financial reporting. The other levels of the conceptual framework provide further guidance for the standard setters when setting accounting standards.

CASE STUDY

The purpose of this case study is to identify whether there are users dependent on general purpose financial reports for information for decision making. The users of information identified in the case are: the parents of children at the centre, the City of Monash, the Commonwealth Government, the Victorian Government and the employees of the centre.

The parents and employees might be identified as those most likely to be dependent users and students should use the criteria in *SACI* to consider whether these groups are, in fact, dependent users.

The most likely conclusion is that the child care centre is a reporting entity.