Chapter 2

THE CONCEPTUAL FRAMEWORK: PURPOSE, REPORTING ENTITY, THE OBJECTIVE OF FINANCIAL REPORTING, AND QUALITATIVE CHARACTERISTICS

LEARNING OBJECTIVES

1 After studying this chapter you should be able to:

2 describe the purpose of a conceptual framework;

3 describe the structure of the Australian conceptual framework;

4 describe the reporting entity concept and the role of general purpose financial reporting;

5 describe the objective of general purpose financial reporting;

6 describe the qualitative characteristics of useful financial information;

7 identify the fundamental characteristics of useful financial information;

8 identify the characteristics that enhance the usefulness of financial information; and

9 identify the nature of the cost constraint on the provision of useful information.

QUESTIONS

1 The role of a conceptual framework is to help provide guidance to accountants and standard setters on how each of the four fundamental issues of definition, recognition, measurement and disclosure is resolved. Framework 2014 has addressed the first three of these issues, but the concept of disclosure has yet to be addressed in a systematic fashion.

A conceptual framework is a normative document because it prescribes how accounting policies *should* be determined. Paragraph 1 of Framework 2014 states that the purpose of the framework is to:

(a) assist the AASB in developing new accounting standards and reviewing those that currently exist;
(b) assist the AASB in promoting harmonisation of regulations, accounting standards, and procedures relating to the presentation of financial statements;
(c) assist preparers of financial statements when they apply accounting standards or deal with topics that are not yet covered by an accounting standard;
(d) assist auditors when they form an opinion as to whether financial statements conform with accounting standards;
(e) assist users of financial statements in interpreting the information in those statements; and
(f) provide those parties who are interested in the AASB's work to understand its approach to formulating accounting standards.

It can be seen from this list of perceived benefits that, although preparers, auditors and users of financial statements are expected to benefit from the development of a conceptual framework, the accounting standard setters should benefit the most. They should be able to use the conceptual framework to:

- develop accounting standards that are more consistent and logical;
- improve their accountability;
- improve the process of communication; and
- save time and money in the development of accounting standards.

2 The current Australian conceptual framework (Framework 2014) as at May 2016 comprises the following two documents:

- *SAC1* 'Definition of the Reporting Entity'; and
- 'Framework for the Preparation and Presentation of Financial Statements'.

SAC1 was issued in August 1990. It defines a reporting entity and provides a basis for identifying those entities that are reporting entities. Reporting entities are expected to publish general purpose financial statements prepared in accordance with the AASB's accounting standards. It should be noted that the IASB has not issued an equivalent document to Australia's *SAC1*.

Framework 2014 is structured as follows:

- The main body of the document specifies the framework's purpose, status and scope, and sets out the concepts associated with the definition, recognition and measurement of the elements of financial statements. The concepts of capital and capital maintenance are also briefly addressed.
- The appendix consists of two chapters. Chapter 1 describes the objective of general purpose financial reporting, and Chapter 3 specifies the qualitative characteristics that financial information should possess if it is to satisfy the objective of general purpose financial reporting. There is currently no Chapter 2, as the IASB has reserved this chapter for the concept of the reporting entity. Australia had already issued *SAC1* on the reporting entity concept before the IASB's framework was adopted.

3 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, SAC2 'Objective of General Purpose Financial Statements', SAC3 'Qualitative Characteristics of Financial Information' and SAC4 'Elements of Financial Statements' have been withdrawn. However, SAC1 'Definition of the Reporting Entity' has been retained because these issues are not dealt with adequately in the IASB document. The IASB updated its conceptual framework and these changes have been adopted in the Australian context as 'Framework for the Preparation and Presentation of Financial Statements' 2014 (Framework 2014).

4 **(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 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 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'.

(c) 'Recognition' 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.

(d) ‘Measurement’ is defined in paragraph 99 of Framework 2014 which states that measurement ‘is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement’.

(e) ‘Disclosure’ is the provision of additional information over and above that which is recognised on the face of the financial statements. These disclosures are made because they provide material information that is useful for users’ decision making.

5 SAC1 notes that general purpose financial statements are designed to meet the common information needs of the users of those statements (which differs from Framework 2014 which notes that 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’). 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.

6 SAC1 notes that general purpose financial statements are designed to meet the common information needs of the users of those statements (which differs from Framework 2014 which notes that 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’). 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 a particular set of users who are requesting those financial statements. Special purpose financial statements are any financial statement other than a general purpose one. 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.

7 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.

8 General purpose financial reports are designed to meet the common information needs of all user groups. Common needs include 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.

However, it is not clear that all external users have common interests as their decision needs may differ. Investors, for example, may be more interested in the earning power of the entity compared to lenders who may be more interested in cash flows and the asset backing of an entity.

9 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.

10 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.

11 The factors identified in *SAC1* 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).

SAC1 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.

12 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.

13 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.

14 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:

(a) five shareholders, each of whom is involved in the company's day-to-day operations;
(b) 100 employees;
(c) customers, mainly in Victoria and South Australia; and
(d) 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.

15 The objective of general purpose financial reporting is now set out in Chapter 1 of the Appendix to Framework 2014 and, in Australia, the objective applies to both for-profit and not-for-profit entities. Paragraph OB2 of Framework 2014 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.'

Understanding the objective of general purpose financial reports provides a basis for identifying the remaining components of the conceptual framework. As decision usefulness for investors and creditors has been set as the objective, accounting standard setters can, at least in principle, address accounting issues in a way that is informed by evidence about what types of definitions, recognition criteria, measurement rules, and disclosure practices are most decision useful to investors and creditors. Of course, in practice, it is much more difficult to observe and agree upon what is decision useful information as users have both common and differing information needs.

16 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. No one basis of measurement has been promoted as superior in Framework 2014 which essentially only notes that alternative measurement bases are available.

17 Accountability is a concept that has been defined and understood in many ways. For example, some commentators view accountability as a concept reflecting stewardship over owners' contributed assets while others take broader definitions that reflect wider responsibilities of management (e.g., responsibility for environmentally sustainable operations). Over time concepts of accountability have arguably broadened. If standard setters can identify an accepted definition of, and demand for, information about accountability, then this would be decision useful. Therefore, although the objective in Framework 2014 emphasises decision-usefulness, this is not incompatible with a need for accountability depending upon what is generally accepted as the definition of accountability. Indeed, paragraph OB4 of Framework 2014 explicitly notes that useful information includes how effectively and efficiently the management or other governing body has discharged its duties.

18 The arguments presented in the answer to Question 9 could also be applied in answer to this question.

19 It is unclear as to who are the 'most important group of users of financial statements' as this is a normative judgement about whose interests should prevail over others. The concept of general purpose financial statements (GPFS) might be interpreted as suggesting that GPFS should serve the information needs that are common across all users of those GPFS. However, in its statement about the objective of GPFS Framework 2014 emphasises the information needs of investors and creditors and it could be argued that the needs of these two groups have been given privileged status relative to other users. This may be because the constitution of the IASB requires it to prepare accounting standards for global capital markets.

20 **(a)** The objective of general purpose financial reporting in Framework 2014 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. Users therefore need information assisting them to assess the amount, timing and uncertainty associated with an entity's future cash flows (para. OB3); and determining the resources available to the entity and the claims on those resources, including information on how effectively and efficiently the management or other governing body has discharged its duties (para. OB4).

(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.

21 Chapter 1 of Framework 2014 identifies the major types of decisions that the primary users make that would be served by general purpose financial statements. In the for-profit sector, these decisions include:

- assisting the users to assess the amount, timing and uncertainty associated with an entity's future cash flows (para. OB3); and
- determining the resources available to the entity and the claims on those resources, including information on how effectively and efficiently the management or other governing body has discharged its duties (para. OB4).

In the not-for-profit sector the types of decisions of interest to the users of general purpose financial statements would include whether the entity has the ability to achieve the financial and non-financial objectives for which it was created (para. AusOB3.1).

With regard to an entity's stock of economic resources and claims on those resources, paragraphs OB13 and OB14 note that general purpose financial statements should help users to assess how the mix of economic resources might have an impact on the pattern of the entity's cash flows and also provide information that assists users to understand the entity's liquidity and solvency. Paragraphs OB15 to OB21 describe how general purpose financial statements should also provide useful information about the changes in an entity's economic resources and claims on those resources. Such changes could arise from the entity's operations or from other events, such as contributions by owners or changes in the market value of the entity's resources. Paragraph OB20 notes that information about the changes in cash flows during a period helps users to understand how the entity's operating, financing and investing activities impact upon its liquidity and solvency. This information describes the entity's sources and uses of cash and allows users to assess whether these cash flows are sustainable in the future.

A great deal of empirical evidence exists to suggest that these needs will generally be provided by conventional financial statements. For example, capital markets research shows that earnings figures matter to investors. However, students could explore ways in which these reports could be improved.

22 The qualitative characteristics of financial information are the attributes or qualities that the information should have if it is to be useful for decision making. If financial information does not have these characteristics, then the objective of general purpose financial reporting cannot be achieved. According to Framework 2014, the fundamental qualitative characteristics of financial information are relevance and faithful representation. The information also has to meet the materiality test. In addition, there are four enhancing qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. They are: comparability, verifiability, timeliness and understandability.

23 This question relates to the qualitative characteristic of *understandability*. Whether information is understandable depends on the users of that information. The understandability of financial information may be influenced by the amount of detail, the use of technical language, the format of the financial statements and so on. To make financial information understandable to as many users as possible, accountants may be tempted to present simple, abbreviated, uncomplicated financial statements. However, such a policy may deprive the general purpose financial statements of other desirable qualities such as relevance and faithful representation. Paragraph QC32 of Framework 2014 recognises the complexities associated with understandability in the context of general purpose financial reporting:

> '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.'

24 The fundamental characteristics that financial information should have for it to be selected for inclusion in general purpose financial statements are relevance and faithful representation. Relevance and faithful representation are discussed in the IASB's *Conceptual Framework for Financial Reporting 2014* (Framework 2014). The financial information should also pass the materiality test.

25 Framework 2014 specifies that for financial information to be relevant, it should have a confirmatory role and a predictive role (para. QC7). Financial information has a confirmatory role when it is used to confirm or correct decision makers' expectations (para. QC9). Financial information has a predictive role when it is used to make predictions of, for example, future cash flows or profit (para. QC8).

26 Financial information may be relevant but, if it is not material, the benefits to users from its selection by the reporting entity would be negligible. Paragraph QC 11 of Framework 2014 states that:

> 'Information is material if omitting it or misstating it could influence the decisions that users make on the basis of financial information about a specific reporting entity.'

The inclusion of immaterial information could reduce the understandability of financial statements. An item is regarded as material if it is likely to influence the decisions of financial statement users.

27 Paragraph QC 12 of Framework 2014 requires useful information to faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation a depiction would have three characteristics. It would be complete, neutral and free from error. To be a complete depiction of an item, all information for a user to understand the item must be provided. To be neutral the depiction of an item must be free from bias in the selection or presentation of the item. The depiction of an item must also be largely, but not necessarily completely, free of error.

28 Sometimes it may be necessary to make a trade-off between relevance and faithful representation. For example, while a substantial delay before publication of financial statements may improve the faithful representation of information in those statements, the relevance of the information would be reduced.

29 The qualitative characteristics that enhance the usefulness of financial information are comparability, verifiability, timeliness and understandability. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date (para. QC 20). Similarly, financial information is more useful to users if it is verifiable and thereby helps to assure users that the information faithfully represents what it purports to represent. Further, the usefulness of financial information is influenced by its timeliness – this involves both the frequency of reporting and the length of time between the end of a reporting period and the publication of the financial report. Finally, information will only be useful if it is understandable to financial information users – financial information is understandable when users of that information can comprehend its meaning.

30 Meeting the objective of general purpose financial reporting requires accounting standard setters to write standards that reflect users' information needs. Surprisingly, the needs of users are often not well understood and standard setters have often had to make assumptions about user needs based, in part, on their own experiences. It might seem a simple solution is to ask users what they want but there are some difficulties wish such an approach including:

- 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 know how useful information that they have never seen might be.
- The decision-making process is not the same for all decision makers. Two people making the same decision may rely on different information and process it in different ways.
- Users may not consider the costs associated with generating information specific to their particular needs. Some types of information may be impracticable or very costly to obtain. If some users (e.g., investment analysts) don't have to bear the cost of producing this information, they will happily ask for it. Other users (e.g.,

shareholders) who bear the costs of information production may be reluctant to provide it!

31 It is acknowledged in Framework 2014 that even though financial information may be relevant and representationally faithful, there may be a cost constraint that prevents it from being provided in general purpose financial statements. Paragraphs QC 35–39 of Framework 2014 consider the importance of the costs and the benefits arising from the provision of some financial information. The measurement of costs and benefits is fraught with difficulties – costs (e.g., information production, compliance) are usually easier to observe than the benefits (e.g., users make better decisions). Note in this context the requirement to prepare a Regulation Impact Statement where the AASB assesses that the standard will involve a medium or significant level of compliance costs.

32 *AASB 108* requires accounting policies to be selected and applied in a manner which ensures that the financial information is relevant and reliable. The accounting standard identifies that where substance and form differ, then the substance rather than the form of a transaction or other event must be reported if information is to be relevant and reliable.

Reporting the substance of a transaction or other event requires that the information reported reflects its economic effect. For example, a preference share would be classified as a financial liability (even though it is called a 'share') if the preference share contained rights that provided for redemption on a specific date. This is because the issuer has an obligation to transfer financial assets to the holder of the preference share (see *AASB 132* 'Financial Instruments: Presentation', para. AG25).