Part 1

THEORY AND PRACTICE

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1 Accounting regulation and the conceptual framework

CHAPTER AIM

This chapter introduces the regulatory framework that governs financial reporting in Australia, including the conceptual framework and accounting standards issued by the Australian Accounting Standards Board (AASB) and the International Accounting Standards Board (IASB), the *Corporations Act 2001* and the Australian Securities Exchange Listing Rules.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. assess whether an entity is a reporting entity in the context of the regulation of financial reporting
2. identify the roles of the key bodies involved in accounting regulation in Australia
3. explain the structure, role and processes of the International Accounting Standards Board (IASB) and the IFRS Interpretations Committee (IFRIC)
4. explain the key components of the conceptual framework
5. explain the qualitative characteristics that make information in financial statements useful
6. discuss the going concern assumption underlying the preparation of financial statements
7. define the basic elements in financial statements — assets, liabilities, equity, income and expenses
8. explain the principles for recognising the elements of financial statements
9. distinguish between alternative bases for measuring the elements of financial statements
10. outline concepts of capital maintenance.

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CONCEPTS FOR REVIEW

Before studying this chapter, you should understand and, if necessary, revise:

- the basic accounting system used to record and classify transactions
- the rules of double-entry accounting and how to apply these rules in analysing transactions
- the purpose and basic format of accounting journals, ledger accounts and financial statements.

LO 1
Assess whether an entity is a reporting entity in the context of the regulation of financial reporting

1.1 Key sources of regulation of financial reporting in Australia

The major sources of regulation of financial reporting in Australia are:
- the *Corporations Act 2001*
- Australian Accounting Standards
- the *Framework for the Preparation and Presentation of Financial Statements*
- the Australian Securities Exchange Listing Rules.

1.1.1 The Corporations Act

Australian companies must comply with the requirements of the *Corporations Act 2001* (the **Corporations Act**). The Corporations Act covers many aspects of the management of companies and the relationships between the company — as a legal person — and directors, shareholders and others. Our discussion of the Corporations Act will focus on its implications for the preparation of financial statements, which are contained in Part 2M.3 of Chapter 2M of the Act.

The Corporations Act requires certain types of entities to prepare financial reports. The categories described in the Corporations Act are as follows.
- *Disclosing entity.* With few exceptions, entities whose securities are listed on a securities exchange are disclosing entities (Corporations Act s. 111AC).
- *Proprietary company.* To qualify for registration as a proprietary company under s. 45A of the Corporations Act a company must:
  - be limited by shares or be an unlimited company with a share capital
  - have no more than 50 non-employee shareholders
  - not do anything that would require disclosure to investors under Chapter 6D (except in limited circumstances).

  Section 45A of the Act further classifies proprietary companies as small or large, as follows.
  – *Small proprietary company.* A small proprietary company is a proprietary company that satisfies at least two of the following criteria, specified in s. 45A(2).
    (a) The consolidated revenue for the financial year of the company and the entities it controls is less than $25 million.
    (b) The value of the consolidated gross assets at the end of the financial year of the company and the entities it controls is less than $12.5 million.
    (c) The company and the entities it controls have fewer than 50 employees at the end of the financial year.
  – *Large proprietary company.* A proprietary company is a large proprietary company if it does not satisfy the definition of a small proprietary company.
- *Public company.* A public company means any company other than a proprietary company.
- *Registered scheme.* A registered scheme refers to a managed investment scheme that is registered under s. 601EB of the Corporations Act.

Accountants face two related questions.
- *Is the entity required to prepare a financial report?*
- *If so, does the report need to comply with Australian accounting standards?*

The answers to these questions are found in the Corporations Act. In relation to the second question, we will also need to refer to the AASB conceptual framework (particularly Statement of Accounting Concepts *SAC 1: Definition of the Reporting Entity*) and AASB 1053 *Application of Tiers of Australian Accounting Standards* for further information about the extent of the application of accounting standards.

Section 292 of the Corporations Act requires the preparation of a financial report and directors' report each financial year. This requirement applies to:

(a) all disclosing entities; and
(b) all public companies; and
(c) all large proprietary companies; and
(d) all registered schemes.

For example, Commonwealth Bank of Australia (CBA) is a public company registered in Australia. It is also a disclosing entity because its shares are listed on the Australian Securities Exchange (ASX). In accordance with s. 292 of the Corporations Act, CBA prepares an annual financial report and a directors' report. The directors' report of CBA includes information about the directors of the company, the company's principal activities, company operations, dividends, and compliance with environmental regulations, as well as a remuneration report.

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Note that small proprietary companies are not required to prepare a financial report or a directors' report under s. 292 of the Corporations Act. Does this mean shareholders of small proprietary companies cannot obtain financial reports on the financial position and performance of the company in which they have invested? No — shareholders holding at least 5% of the voting power may give the company a direction to prepare a financial report and directors' report under s. 293 or, in the case of a small proprietary company limited by guarantee, a members' direction in accordance with s. 294A. When shareholders and members make directions for the preparation of financial reports they may specify that the report does not have to comply with accounting standards or that some part of the report does not have to be prepared. They may also specify whether the financial report needs to be audited. In addition, the Australian Securities and Investments Commission (ASIC) may make a direction for a small proprietary company to prepare a financial report and a directors' report under s. 294 or s. 294B. Section 292(2)(b) requires foreign-controlled small proprietary companies to prepare a financial report if the parent did not lodge consolidated financial reports for that year with ASIC.

Table 1.1 details the reporting requirements for various types of entities under the Corporations Act.

ILLUSTRATIVE EXAMPLE 1.1 | Preparation of a financial report according to the Corporations Act

Nature Walk Resort Pty Ltd is a proprietary company that operates a resort in the Australian outback. It has 10 shareholders and 28 employees. According to internal accounting records, Nature Walk Resort Pty Ltd has total assets of $14 million and total liabilities of $5 million. Its revenue for the current year was $27 million. Neither ASIC nor shareholders have made a direction for the preparation of a financial report.

Is Nature Walk Resort Pty Ltd required to prepare a financial report?

Nature Walk Resort Pty Ltd is required to prepare a financial report in accordance with s. 292 of the Corporations Act because it is a *large proprietary company*. Nature Walk Resort Pty Ltd fails to satisfy the definition of a small proprietary company because it does not meet the minimum of two of the three criteria specified in s. 45A(2) of the Corporations Act. The company has less than 50 employees, but its total revenue is more than $25 million and total assets are more than $12.5 million.

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Table 1.1 Reporting requirements for various types of entities under the Corporations Act

Type of entity	Reporting requirements
Disclosing entity	Disclosing entities are required to comply with continuous disclosure requirements and prepare annual and half-year reports that include a directors' report and directors' declaration, financial statements as required by the Australian accounting standards, and notes to the financial statements. Disclosing entities must have the financial report audited in accordance with Division 3 of Part 2M.3 of the Corporations Act and lodge the financial report, together with the directors' report and auditor's report, with ASIC.
Small proprietary company	Small proprietary companies are not required to prepare annual financial reports in accordance with Chapter 2M of the Corporations Act unless directed by ASIC or shareholders with at least 5% of the voting rights.
Large proprietary company	Large proprietary companies are required to prepare annual financial reports in accordance with Chapter 2M of the Corporations Act, and have the annual reports audited and sent to members within 4 months of the end of the financial year.
Public company	Public companies are required to prepare annual financial reports in accordance with Chapter 2M, have them audited, and lodge them with ASIC within 4 months of the end of the financial year. The reports must be sent to members by the earlier of 4 months after year-end or 21 days before the next annual general meeting.
Registered scheme	Responsible entities of the registered scheme must prepare financial reports, a directors' report and an auditor's report each financial year and lodge them with ASIC within 3 months of the end of the financial year.

The financial statements, including the notes, for a financial year must provide a true and fair view of the financial position and performance of the entity (Corporations Act s. 297). This section does not affect the obligation under s. 296 to comply with accounting standards. In other words, companies cannot rely on presenting a

true and fair view as an excuse for non-compliance with accounting standards. So what should the directors of a company do if they believe that compliance with accounting standards would not produce a true and fair view? In these circumstances the Corporations Act requires compliance with accounting standards and the inclusion of additional information in the notes to the financial statements so as to give a true and fair view.

The term 'true and fair' is not defined in the Corporations Act. However, auditing standard ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* indicates that 'gives a true and fair view' and 'presents fairly' are equivalent in all material respects. According to paragraph 15 of AASB 101 *Presentation of Financial Statements*, fair presentation requires the:

> faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*.

The requirements for additional disclosure in the notes when necessary to present a true and fair view are considered further in chapter 16.

1.1.2 Australian accounting standards

Section 296 of the Corporations Act requires compliance with accounting standards issued by the AASB. Under the direction of the Financial Reporting Council (FRC), the AASB adopted **International Financial Reporting Standards (IFRSs)**, effective for reporting periods commencing on or after 1 January 2005. To achieve this, the AASB issues Australian Accounting Standards with requirements that are the same as those of IFRSs for application by for-profit entities.

The requirements of IFRSs have a significant impact on financial reporting in Australia because the standards issued by the AASB are Australian equivalents of IFRSs. So what are IFRSs? International Financial Reporting Standards comprise the authoritative pronouncements issued by the International Accounting Standards Board (IASB). They include two series of accounting standards and two series of interpretations:

- standards that are labelled IFRS (e.g. IFRS 8 *Operating Segments*)
- standards that originated as part of the older series of International Accounting Standards, originally issued by the International Accounting Standards Committee and reissued or revised and reissued by the IASB (e.g. IAS 16 *Property, Plant and Equipment*)
- interpretations issued by the IFRS Interpretations Committee (e.g. IFRIC 13 *Customer Loyalty Programmes*)
- interpretations issued by the former Standing Interpretations Committee (e.g. SIC 32 *Intangible Assets — Web Site Costs*).

The Australian equivalents of the IASB's 'IFRS' series are numbered from AASB 1. For example, the Australian equivalent of IFRS 8 *Operating Segments* is AASB 8 *Operating Segments*. The Australian equivalents of the IASB's 'IAS' series are numbered from AASB 101. For example, the Australian equivalent of IAS 16 *Property, Plant and Equipment* is AASB 116 *Property, Plant and Equipment*.

The AASB also issues Australian accounting standards that are not an equivalent of a corresponding standard issued by the IASB. These standards typically cover specific local requirements, such as additional disclosure requirements, and requirements for not-for-profit and public sector entities; for example, AASB 1051 *Land Under Roads,* which applies to the financial statements of various public sector entities.

The Corporations Act requires compliance with Australian accounting standards, which, in turn, are consistent with IFRSs. IFRSs include both standards and interpretations issued by the IASB. Interpretations do not have the same status as accounting standards under the Corporations Act. The AASB has addressed this problem by bringing the content of interpretations into the ambit of accounting standards. This is achieved through AASB 1048 *Interpretation of Standards.*

As noted above, accounting standards issued by the AASB have legislative backing under s. 334 of the Corporations Act. An exception is provided for small proprietary companies that prepare financial reports under the direction of shareholders or members, where the direction specifies that the report does not have to comply with accounting standards.

The inclusion of the **reporting entity** concept in most Australian accounting standards establishes a form of **differential reporting** whereby certain entities are allowed to adopt substantially reduced disclosures while complying with the recognition, measurement and presentation requirements of accounting standards. Most Australian accounting standards apply only to:

- each entity that is required to prepare financial statements in accordance with Part 2M.3 of the Corporations Act *and that is a reporting entity*
- general purpose financial statements of each *reporting entity*
- financial statements that are, or are held out to be, general purpose financial statements (essentially capturing those entities which opt for the preparation of general purpose financial statements).

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The reporting entity concept is used to determine whether entities are required to prepare general purpose financial statements. Paragraph 40 of SAC 1 *Definition of the Reporting Entity,* which forms part of the Australian conceptual framework, states:

> Reporting entities are all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

Deciding whether an entity is a reporting entity requires professional judgement. The critical factor in identifying an entity as a reporting entity is the existence of users who depend on general purpose financial statements produced by that entity for resource allocation decisions. Where dependence is not readily apparent, SAC 1 suggests some factors that might indicate the existence of user dependence:

> 20 The greater the spread of ownership/membership and the greater the extent of the separation between management and owners/members or others with an economic interest in the entity, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.
>
> 21 Economic or political importance/influence refers to the ability of an entity to make a significant impact on the welfare of external parties. The greater the economic or political importance of an entity, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions. Reporting entities identified on the basis of this factor are likely to include organisations which enjoy dominant positions in markets and those which are concerned with balancing the interests of significant groups, for example, employer/employee associations and public sector entities which have regulatory powers.
>
> 22 Financial characteristics that should be considered include the size (for example, value of sales or assets, or number of employees or customers) or indebtedness of an entity. In the case of non-business entities in particular, the amount of resources provided or allocated by governments or other parties to the activities conducted by the entities should be considered. The larger the size or the greater the indebtedness or resources allocated, the more likely it is that there will exist users dependent on general purpose financial reports as a basis for making and evaluating resource allocation decisions.

Note that the definition of reporting entity requires only that there be a reasonable expectation that users exist. Thus an entity cannot claim to be a non-reporting entity merely because it is not aware of the identity of particular users.

Users who are able to demand financial statements to meet their specific needs would not be considered dependent users. The specific needs of such users can be satisfied through the preparation of special purpose financial statements. For example, the information needs of taxation authorities can often be satisfied by the preparation of financial statements tailored to meet their specific needs.

Does this mean that a non-reporting entity that is required to prepare a financial report in accordance with Chapter 2M of the Corporations Act need not be concerned with Australian accounting standards (other than AASB 101, AASB 107, AASB 108 and AASB 1048)? Not exactly. The guidance issued by ASIC on the application of the reporting entity concept in 'Regulatory Guide 85: Reporting requirements for non-reporting entities' specifies that the definition and measurement requirements of other Australian accounting standards should also be applied by non-reporting entities. Figure 1.1 provides an extract from Regulatory Guide 85 that explains why non-reporting entities should apply the recognition and measurement requirements of Australian accounting standards when preparing financial reports in accordance with the Corporations Act.

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Figure 1.1 Application of recognition and measurement requirements to non-reporting entities

Section 2: Accounting provisions applicable to non-reporting entities

2.1 The accounting standards provide a framework for determining a consistent meaning of 'financial position' and 'profit or loss' in financial reporting across entities.

2.2 In the absence of any such framework, the figures disclosed in financial statements would lose their meaning and could be determined completely at the whim of the directors of individual entities. The profit or loss reported by an individual entity would vary greatly depending upon which individuals were responsible for the preparation of its financial statements.

2.3 This would not be consistent with the requirements of the Act for financial reports to give a true and fair view (s. 297), prohibiting the giving of false and misleading information (s. 1308), and only permitting dividends to be paid out of profits (s. 254T).

2.4 The following requirements of accounting standards that apply to all entities reporting under Chapter 2M are also relevant:

(a) Paragraph 13 of accounting standard AASB 101 *Presentation of Financial Statements* requires the financial report to present fairly the financial position, financial performance and cash flows. Fair presentation requires 'the faithful representation of the effects of transactions, other events and conditions' in accordance with the definitions and recognition criteria for 'assets', 'liabilities', 'income' and 'expenses' set out in the *Framework for the Preparation and Presentation of Financial Statements (Framework).*

(continued)

Figure 1.1 *(continued)*

(b) Paragraph 25 of AASB 101 requires all entities reporting under Chapter 2M to apply the accrual basis of accounting.
(c) Paragraphs 10 and 11 of AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides that, in the absence of an Australian Accounting Standard that specifically applies to a transaction, other event or condition, management should refer to, and consider the applicability of, the following sources in descending order:
 (i) the requirements and guidance in Australian Accounting Standards dealing with similar and related issues; and
 (ii) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework.*

2.5 Hence, the recognition and measurement requirements of accounting standards must also be applied in order to determine the financial position and profit or loss of any entity preparing financial reports in accordance with the Act.

2.6 As noted earlier, the recognition and measurement requirements of the accounting standards include requirements relating to depreciation of non-current assets, tax effect accounting, lease accounting, measurement of inventories, and recognition and measurement of liabilities for employee entitlements.

2.7 The provisions of accounting standards dealing with the classification of items as assets, liabilities, equity, income and expenses also apply. This would include the provisions of AASB 132 *Financial Instruments: Disclosure and Presentation* concerning the classification of financial instruments issued as debt or equity.

2.8 Class Order [CO 05/639] *Application of accounting standards by non-reporting entities* allows non-reporting entities to take advantage of concessions to the measurement requirements of accounting standards. Examples of these concessions include the provisions of AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards* and transitional provisions in new accounting standards.

2.9 Directors of non-reporting entities must also consider carefully the need to make disclosures which are not directly prescribed by accounting standards, but which may be necessary in order for the financial statements to give a true and fair view. Such disclosures could include certain significant related party transactions.

2.10 ASIC will look closely at cases where non-reporting entities have not complied with the recognition and measurement requirements of accounting standards.

2.11 Non-reporting entities which hold out their financial reports to be general purpose financial reports must comply with all requirements of accounting standards.

Source: ASIC (2005, pp. 5–6).

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In 2010, the AASB provided further guidance on differential reporting by issuing an accounting standard AASB 1053 *Application of Tiers of Australian Accounting Standards* which introduces a two-tiers reporting system for companies producing general purpose financial statements. Companies complying with Tier 1 requirements will comply with all relevant accounting standards, whereas Tier 2 comprises the recognition, measurement and presentation requirements of Tier 1 but has substantially reduced disclosure requirements in comparison with Tier 1. Each Australian accounting standard sets out the disclosure requirements from which Tier 2 entities are exempted. This differential reporting requirement applies to annual reporting periods beginning on or after 1 July 2013. In relation to which companies shall comply with Tier 1 reporting requirements, paragraph 11 of AASB 1053 states:

> Tier 1 reporting requirements shall apply to the general purpose financial statements of the following types of entities:
> (a) for-profit private sector entities that have public accountability; and
> (b) the Australian Government and State, Territory and Local Governments.

Given that public accountability is central to the requirement, Appendix A of AASB 1053 provides the definition as follows.

> Public accountability means accountability to those existing and potential resource providers and others external to the entity who make economic decisions but are not in a position to demand reports tailored to meet their particular information needs.
> A for-profit private sector entity has public accountability if:
> (a) its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or
> (b) it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks.

Paragraph B2 of Appendix B to AASB 1053 further states:

> The following for-profit entities are deemed to have public accountability:
> (a) disclosing entities, even if their debt or equity instruments are not traded in a public market or are not in the process of being issued for trading in a public market;
> (b) co-operatives that issue debentures;
> (c) registered managed investment schemes;

(d) superannuation plans regulated by the Australian Prudential Regulation Authority (APRA) other than Small APRA Funds as defined by APRA Superannuation Circular No. III.E.1 *Regulation of Small APRA Funds,* December 2000; and
(e) authorised deposit-taking institutions.

In regards to the types of companies that shall at least apply Tier 2 reporting requirements in preparing general purpose financial statements, paragraph 13 of AASB 1053 lists:

(a) for-profit private sector entities that do not have public accountability;
(b) not-for-profit private sector entities; and
(c) public sector entities, whether for-profit or not-for-profit, other than the Australian Government and State, Territory and Local Governments.

In sum, for example, a large proprietary company must at least prepare Tier 2 financial statements. Companies applying Tier 2 reporting requirements would not be able to state compliance with IFRSs unless they elect to also apply Tier 1 reporting requirements.

Paragraph BC6 of AASB 1053 states that all companies including those eligible for the Tier 2 reduced reporting burden must apply in full the following Australian accounting standards:

- AASB 101 *Presentation of Financial Statements* (refer to chapter 16)
- AASB 107 *Statement of Cash Flows* (refer to chapter 17)
- AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* (refer to chapter 18)
- AASB 1048 *Interpretation of Standards.*

ILLUSTRATIVE EXAMPLE 1.2 | Application of Australian accounting standards

Seaside Resorts Pty Ltd is a proprietary company that operates a holiday resort in the Whitsundays. It has 10 shareholders, all of whom are involved in the management of the company. Seaside Resorts Pty Ltd has 33 employees. According to internal accounting records, Seaside Resorts Pty Ltd has total assets of $28 million and total liabilities of $10 million, most of which represents a secured bank loan. Seaside Resorts Pty Ltd must provide the bank with financial information each year as specified in the loan agreement. Seaside Resorts Pty Ltd's revenue for the current year was $24 million. Neither ASIC nor shareholders have made a direction for the preparation of a financial report.

Does Seaside Resorts Pty Ltd need to prepare a financial report and apply Australian accounting standards?

To address this question, it is necessary to first consider whether the Corporations Act requires Seaside Resorts Pty Ltd to prepare a financial report. If so, then we must consider whether Seaside Resorts Pty Ltd is a reporting entity and the implications of being either a reporting entity or a non-reporting entity.

Seaside Resorts Pty Ltd is not required to prepare a financial report in accordance with s. 292 of the Corporations Act because it is a small proprietary company. Seaside Resorts Pty Ltd satisfies the definition of a small proprietary company because it meets two of the three criteria specified in s. 45A(2) of the Corporations Act, by having fewer than 50 employees and revenue less than $25 million even though the company's total assets exceed $12.5 million.

Seaside Resorts Pty Ltd is unlikely to be considered a reporting entity. The shareholders are unlikely to be dependent upon general purpose financial statements for their information needs because they are able to access internal financial information through their involvement in management. The major creditor is a bank that is able to demand special purpose financial statements under the terms of the loan. While it could be argued that employees are potential users of general purpose financial statements, Seaside Resorts Pty Ltd does not have many employees. Thus, it is not reasonable to expect the existence of users dependent upon general purpose financial statements.

However, if Seaside Resorts Pty Ltd is directed by the shareholders with at least 5% voting power to prepare a financial report under s. 293 of the Corporations Act, the financial report must comply with AASB 101, AASB 107, AASB 108 and AASB 1048 in full and apply the recognition and measurement requirements of accounting standards. Given that the company does not have public accountability, it is allowed to provide reduced disclosure through a regime of partial or full exemptions from the relevant accounting standards.

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1.1.3 A conceptual framework

The purpose of a conceptual framework is to provide a coherent set of principles:

- to assist standard setters to develop a consistent set of accounting standards for the preparation of financial statements
- to assist preparers of financial statements in the application of accounting standards and in dealing with topics that are not the subject of an existing applicable accounting standard
- to assist auditors in forming an opinion about compliance with accounting standards
- to assist users in the interpretation of information in financial statements.

In Australia, the conceptual framework includes the AASB's *Framework for the Preparation and Presentation of Financial Statements* (which incorporates the IASB's *Conceptual Framework for Financial Reporting*) and

Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity*. The AASB intends to incorporate the IASB's forthcoming chapter on reporting entity into the Australian conceptual framework, which will potentially see the withdrawal of SAC 1. The conceptual framework is considered in more detail in sections 1.4 to 1.10.

AASB 108/IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires preparers to consider the definitions, recognition criteria and measurement concepts in the conceptual framework when developing accounting policies for transactions, events or conditions in the absence of an Australian accounting standard that specifically applies or that applies to similar circumstances. AASB 108 is considered in more detail in chapter 18.

1.1.4 Australian Securities Exchange Listing Rules

The **Australian Securities Exchange** Group **(ASX)** requires companies that list on the stock exchange to comply with the **ASX Listing Rules**, which deal with listing and quotation, market information, trading and settlement, and general supervisory matters. The principles underlying the Listing Rules embrace the interests of listed entities and investors and seek to maintain the reputation of the market. Figure 1.2 shows some of the principles that underpin the ASX Listing Rules, selected on the basis of their relevance to financial reporting.

Figure 1.2 Selected principles that underpin the ASX Listing Rules

Source: ASX, www.asx.com.au.

- An entity should satisfy appropriate minimum standards of quality, size and operations and disclose sufficient information about itself before it is admitted to the official list.
- Timely disclosure should be made of information which may have a material effect on the price or value of an entity's securities.
- Information should be produced to high standards and, where appropriate, enable ready comparison with similar information.
- Information should be disclosed to enable investors to assess an entity's corporate governance practices.

The Listing Rules include requirements for continuous disclosure and periodic reporting. In accordance with ASX General Rule 3.1, if an entity 'is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information'. Listing Rule 3.1A provides for exceptions to General Rule 3.1 where all of the following conditions are satisfied.

- A reasonable person would not expect the information to be disclosed.
- The information is confidential and ASX has not formed the view that the information ceased to be confidential and at least one of the following applies.
  - It would be a breach of a law to disclose the information.
  - The information concerns an incomplete proposal of negotiation.
  - The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
  - The information is generated for the internal management purposes of the entity.
  - The information is a trade secret.

The Listing Rules are primarily concerned with disclosure rather than with the accounting policies applied in determining classifications and amounts reported in financial statements.

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LEARNING CHECK

- ☐ The *Corporations Act 2001* (the Corporations Act) specifies reporting requirements for various reporting entities. It stipulates the types of entities that are required to prepare financial statements and a directors' report each financial year.
- ☐ Under the Corporations Act, entities required to issue financial statements must comply with the Australian accounting standards, issued by the Australian Accounting Standards Board (AASB).
- ☐ SAC 1 provides the definition of the reporting entity. AASB 1053 specifies 2-tier disclosure requirements for general purpose financial statements. It stipulates the extent of the compliance required under the differential reporting requirements.
- ☐ The AASB, following a directive from the FRC, has adopted accounting standards issued by the IASB for use in Australia, and is responsible for development of accounting standards in the public and not-for-profit sectors in Australia.
- ☐ The AASB has taken on the task of adopting the interpretations issued by the IFRS Interpretations Committee for use in the Australian context.
- ☐ A conceptual framework is a set of principles to assist: standard setters to develop a consistent set of accounting standards; preparers of financial statements in the application of accounting standards; auditors in forming an opinion in relation to compliance with accounting standards; and users in the interpretation of information in financial statements.
- ☐ The Australian conceptual framework consists of the *Framework for the Preparation and Presentation of Financial Statements* (incorporating the IASB's *Conceptual Framework for Financial Reporting*) and SAC 1 *Definition of the Reporting Entity*.
- ☐ A company listing on the ASX must comply with the Listing Rules, which generally require additional enhanced disclosure.

1.2 The role of key players in financial reporting regulation

LO 2 Identify the roles of the key bodies involved in accounting regulation in Australia

The key players in standard setting in Australia are the Financial Reporting Council (FRC) and the AASB. A diagrammatic representation of the Australian accounting standard-setting institutional arrangements is shown in figure 1.3.

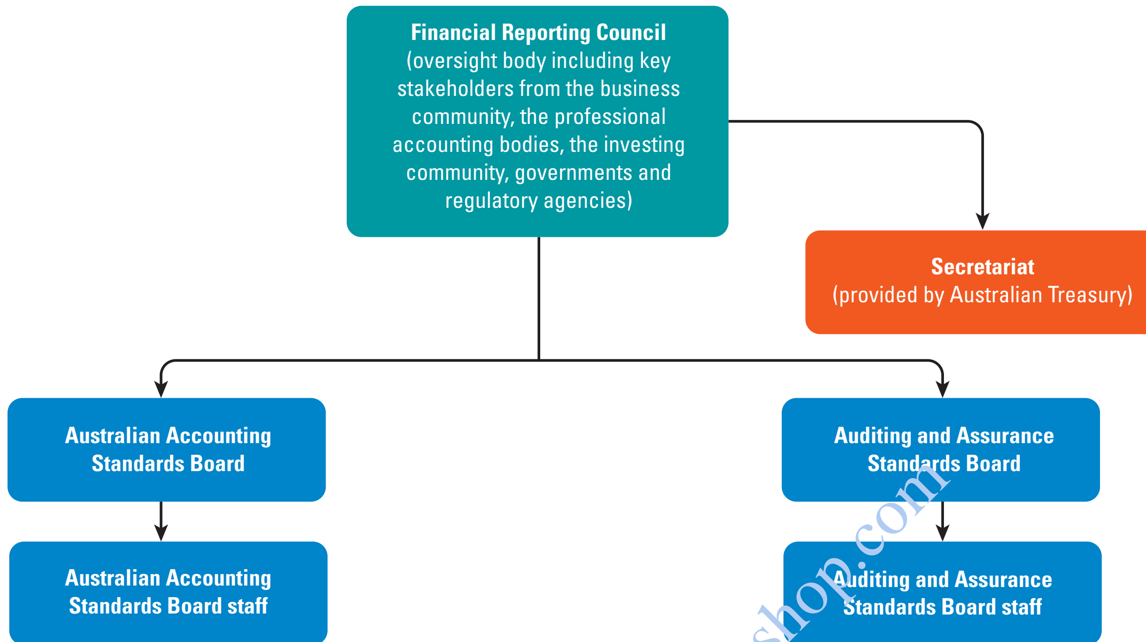

Figure 1.3 Australian accounting standard-setting institutional arrangements
Source: FRC (2008).

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Other key players in financial reporting regulation include the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the Australian Securities Exchange Group (ASX). The role of each body is discussed, in turn, below.

Professional accounting bodies, such as CPA Australia, the Institute of Chartered Accountants in Australia and the Institute of Public Accountants, also play a part in accounting regulation. They contribute to the standard-setting process by responding to exposure drafts and other invitations to comment, as well as communicating information to their members about developments in accounting standards and other accounting regulations, and providing professional development resources. Another important role of the professional bodies is in the regulation of accountants through professional codes of conduct. The focus of this chapter is on the regulation of financial reporting, rather than the regulation of accountants. As such, we do not elaborate on the role of the professional bodies. More information about the professional accounting bodies can be obtained from their websites:

- CPA Australia: www.cpaaustralia.com.au
- The Institute of Chartered Accountants in Australia: www.charteredaccountants.com.au
- The Institute of Public Accountants: www.publicaccountants.org.au.

1.2.1 Financial Reporting Council (FRC)

The **Financial Reporting Council (FRC)** is a statutory body under the *Australian Securities and Investments Commission Act 2001* (the ASIC Act 2001), as amended by the *Corporate Law Economic Reform Program* (*Audit Reform and Corporate Disclosure*) *Act 2004*. The FRC has responsibility for the broad oversight of the processes for setting accounting standards. The general functions of the FRC established by s. 225(1) of the ASIC Act 2001 are:

(a) to provide broad oversight of the processes for setting accounting standards in Australia; and
(b) to provide broad oversight of the processes for setting auditing standards in Australia; and
(c) to monitor the effectiveness of auditor independence requirements in Australia; and
(d) to give the Minister reports and advice about the matters referred to in paragraphs (a), (b) and (c); and
(e) the functions specified in subsections (2) (specific accounting standards functions), (2A) (specific auditing standards functions) and (2B) (specific auditor independence functions); and
(f) to establish appropriate consultative mechanisms; and

(g) to advance and promote the main objects of this Part; and
(h) any other functions that the Minister confers on the FRC by written notice to the FRC Chair.

Section 225(2) also details the specific accounting standards functions of the FRC, these being:

(a) appointing the members of the AASB (other than the Chair); and
(b) giving the AASB advice or feedback on the AASB's:
  (i) priorities; and
  (ii) business plans; and
  (iii) procedures; and
(ba) giving the Office of the AASB advice or feedback on the Office's:
  (i) budgets; and
  (ii) staffing arrangements (including level, structure and composition of staffing); and
(c) determining the AASB's broad strategic direction; and
(e) monitoring the development of international accounting standards and the accounting standards that apply in major international financial centres; and
(f) furthering the development of a single set of accounting standards for world-wide use with appropriate regard to international developments; and
(g) promoting the continued adoption of international best practice accounting standards in the Australian Accounting Standard setting processes if doing so would be in the best interests of both the private and public sectors in the Australian economy; and
(h) monitoring:
  (i) the operation of accounting standards to assess their continued relevance and their effectiveness in achieving their objectives in respect of both the private and public sectors of the Australian economy; and
  (ii) the effectiveness of the consultative arrangements used by the AASB.

In 2002, the FRC exercised its power to determine the AASB's broad strategic direction with a directive to adopt IFRSs. As a result, Australia adopted IFRSs effective for reporting periods commencing on or after 1 January 2005. Notwithstanding this strategic direction, the key determinant in selecting Australian accounting standards is that they be in the best interests of both the private and public sectors in the Australian economy. Sections 225(5) and 225(6) impose explicit limits on the power of the FRC that:

- the FRC does not have power to direct the AASB in relation to the development or making of a particular standard
- the FRC does not have power to veto a standard made, formulated or recommended by the AASB.

Although the FRC may provide strategic direction to the AASB, it cannot direct the board to make a specific standard or to provide specific solutions to accounting issues. Details about the rules of operation of the FRC, including meeting procedures, charter of functions and framework for appointment of members, are available on the FRC website at www.frc.gov.au.

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1.2.2 Australian Accounting Standards Board (AASB)

The AASB is an Australian government agency under the ASIC Act 2001. The FRC appoints the members of the AASB, except the chair, who is appointed by the treasurer of the Australian government. The AASB has the authority to issue Australian accounting standards. The functions of the AASB are specified in s. 227(1) of the ASIC Act 2001 as follows:

- to develop a conceptual framework for the purpose of evaluating proposed accounting standards
- to make accounting standards under s. 334 of the Corporations Act
- to formulate accounting standards for other purposes
- to participate in and contribute to the development of a single set of accounting standards for worldwide use
- to advance and promote the main objects of the Australian financial reporting system part of the ASIC Act.

The AASB must have regard to the interests of Australian corporations that raise or propose to raise capital in major international financial centres. This requirement can be a source of tension because Australian accounting standards must also be applied by many entities that do not raise finance in international capital markets. Providing certain disclosures has expected benefits in terms of lower cost of capital. Such benefits are more likely to be realised by entities that compete for funds in global capital markets.

The AASB may formulate an accounting standard by issuing the text of an international accounting standard (s. 227(4)). The text of the international accounting standard may be 'modified to the extent necessary to take account of the Australian legal or institutional environment and, in particular, to ensure that any disclosure and transparency provisions in the standard are appropriate to the Australian legal or institutional environment'. While the ASIC Act limits the modifications that the AASB may make to international accounting standards, it does not limit the capacity of the AASB to formulate new accounting standards that are not equivalent to, or are modifications of, an international standard. For example, AASB 1054 *Australian Additional Disclosures*, which was issued by the AASB, is not based on a standard issued by the International Accounting Standards Board.

The AASB has power under s. 227(3) of the ASIC Act 2001 to establish committees, advisory panels and consultative groups. At the time of writing, the AASB has two focus groups: the User Focus Group, which comprises representatives of financial statement users such as investors and investment professionals, equity and credit analysts, credit grantors and rating agencies; and the Not-for-Profit (Private Sector) Focus Group, which comprises representatives of financial statement preparers, donors, credit grantors and community agencies in that sector. Project Advisory panels comprise a group of people appointed for their expertise on a particular topic. The AASB may appoint an interpretation advisory panel, constituted as a committee of the AASB, on a topic-by-topic basis. The Interpretation Advisory panels may prepare alternative views on an issue and make recommendations for consideration by the AASB.

Figure 1.4 outlines the process for setting Australian accounting standards. Technical issues may be identified by international standards organisations, such as the IASB or the Financial Accounting Standards Board (FASB) in the United States. They may alternatively be identified by sources within Australia, such as members or staff of the AASB or other stakeholders. Once an item has been added to the board's agenda and it has researched and considered an issue, consultation with stakeholders may proceed with the issue of exposure drafts, invitations to comment, draft interpretations and discussion papers. Exposure drafts issued by the AASB often incorporate exposure drafts issued by the IASB, along with Australian-specific matters for comment as applicable. Exposure drafts can be accessed on the AASB's website. The consultation process may involve roundtable discussions with stakeholders and consultation with focus groups, project advisory panels and interpretation advisory panels, as well as the receipt of submissions in response to exposure drafts and other documentation on which the AASB publicly invites comment.

AASB Standard-Setting Process

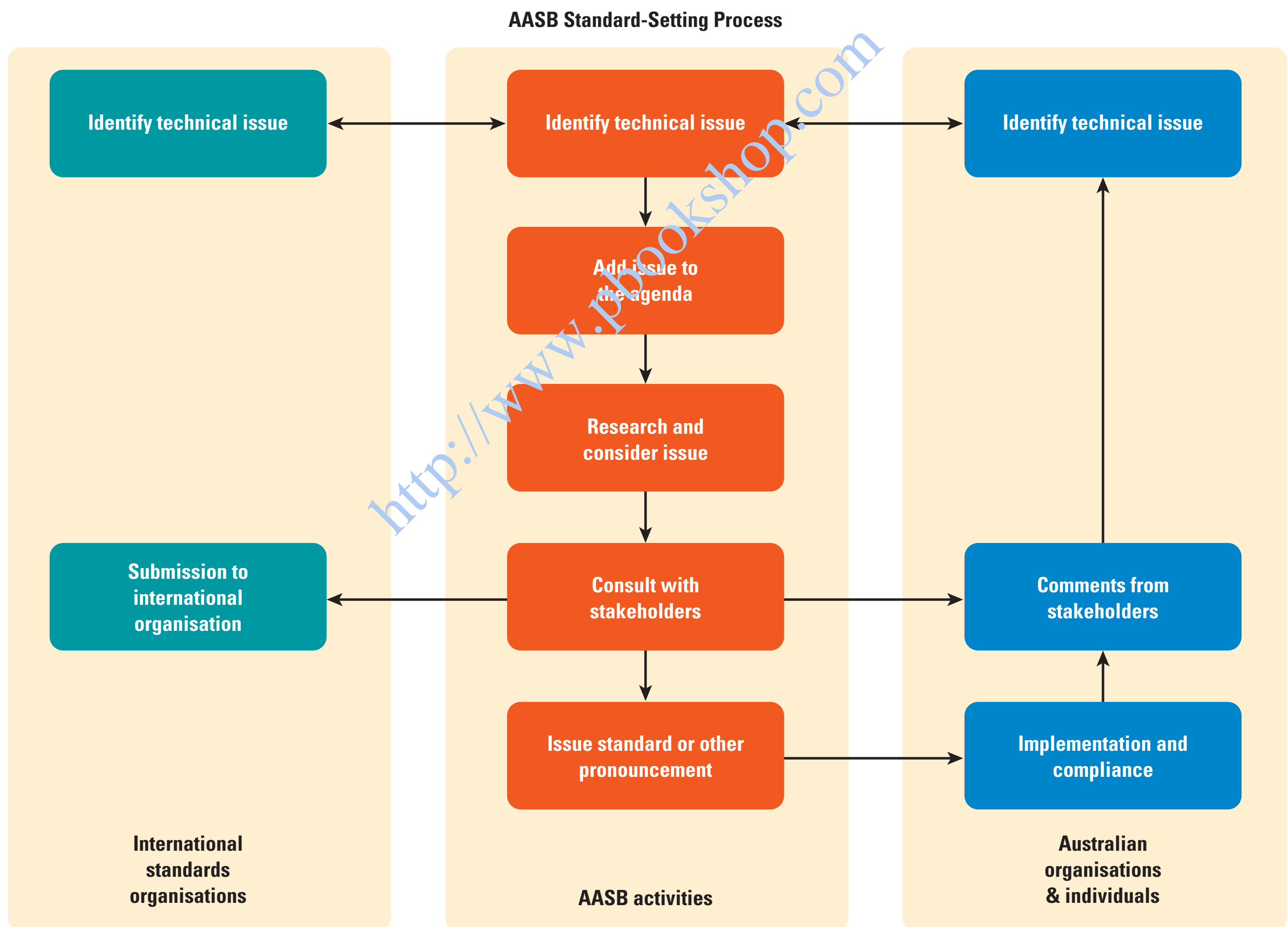

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Figure 1.4 AASB standard-setting process

Source: AASB (2014).

More information about the AASB can be found on its website, www.aasb.gov.au.

1.2.3 Australian Securities and Investments Commission (ASIC)

The **Australian Securities and Investments Commission (ASIC)** is Australia's corporate, markets and financial services regulator. It administers the Corporations Act. Figure 1.5 outlines the functions of ASIC under the ASIC Act 2001.

Figure 1.5
Functions of ASIC
Source: ASIC, www.asic.gov.au

> The *Australian Securities and Investments Commission Act 2001* requires ASIC to:
> - maintain, facilitate and improve the performance of the financial system and entities in it
> - promote confident and informed participation by investors and consumers in the financial system
> - administer the law effectively and with minimal procedural requirements
> - enforce and give effect to the law
> - receive, process and store, efficiently and quickly, information that [it receives]
> - make information about companies and other bodies available to the public as soon as practicable.

ASIC undertakes financial reporting surveillance with the purpose of improving the quality of financial reporting. Entities' financial statements are selected for review. The selection is based on several criteria including the current issues, or 'hot topics', in financial reporting and public complaints. The financial statements are reviewed for compliance with the Corporations Act and Australian accounting standards. ASIC informs the entity if it has any concerns about its financial statements and invites the issuer to explain the accounting treatment used. ASIC publishes the findings of its surveillance program on its website, www.asic.gov.au. Figure 1.6 provides an extract from ASIC's report on its reviews of 31 December 2013 financial reports.

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Figure 1.6
Results of ASIC's review of 31 December 2013 financial reports
Source: ASIC (2014).

1. Asset values and impairment testing

ASIC continues to identify concerns regarding assessments of the recoverability of the carrying values of assets, including goodwill, other intangibles, and property, plant and equipment.

As a result of ASIC inquiries, a number of entities have made significant impairment write-downs and will improve their disclosures on matters such as key assumptions.

Findings include:

(a) Determining the carrying amount of cash generating units: There are cases where entities:
- appear to have identified CGUs at too high a level or used single CGUs where cash flows for individual assets are largely independent, resulting in cash flows from one asset or part of the business being incorrectly used to support the carrying values of other assets
- did not include all assets that generate the cash inflows in the carrying amount of a cash generating unit (CGU), such as inventories and trade receivables
- incorrectly included the benefit of tax losses in determining the recoverable amount of a CGU, and
- incorrectly deducted liabilities from the carrying amount of a CGU.

(b) Reasonableness of cash flows and assumptions: There continue to be cases where the cash flows and assumptions used by entities in determining recoverable amounts are not reasonable or supportable having regard to matters such as historical cash flows, the manner in which an entity is funded and market conditions.

In particular, we found cases where:
- cash flows for value in use calculations included estimated future cash inflows or outflows expected to arise from future restructuring or development plans
- assumptions derived from external sources were not assessed for consistency and relevance, and
- forecasts extended beyond five years for value in use calculations even though the entity had a poor history of making forecasts.

(c) Fair value assessments of recoverable amounts under AASB 13: In their fair value assessment we still see entities using discounted cash flow techniques that are dependent on a large number of management inputs, without considering recoverable amounts for comparable transactions, where available. Where it is not possible to determine fair value because there is no basis for making a reliable estimate of the price that would be received to sell an asset in an orderly transaction between market participants, the entity may need to attribute the asset's value in use as its recoverable amount.

(d) Impairment indicators: Some entities are not attaching appropriate weight to impairment indicators, such as obsolescence and market capitalisation, relative to reported net assets.

Figure 1.6
(continued)

(e) **Disclosures:** A number of entities are not making necessary disclosure of:
- sensitivity analysis where there is limited excess of an asset's recoverable amount over the carrying amount and where a reasonably possible change in an assumption(s) could lead to impairment
- key assumptions including discount rates and growth rates, and
- periods covered by forecasts.

These disclosures are important to investors and other users of financial reports given the subjectivity of these calculations/assessments. They enable users to make their own assessments about the carrying values of the entity's assets and risk of impairment given the estimation uncertainty associated with many asset valuations.

This item includes matters arising from the finalisation of impairment matters identified in our reviews of 30 June 2013 financial reports.

2. Off-balance sheet arrangements and new standards

Accounting standards AASB 10 *Consolidated Financial Statements*, AASB 11 *Joint Arrangements*, AASB 12 *Disclosure of Interests in Other Entities* and AASB 13 *Fair Value Measurement*, applied to full year financial reports for the first time. The first two standards can significantly change the identification of controlled entities and accounting for joint arrangements. The fourth can affect aspects of the determination of fair values of financial instruments or other assets.

ASIC is making enquiries on the non-consolidation of some entities, including some majority-owned entities and of one entity regarding the appropriateness of accounting for a joint arrangement.

3. Tax accounting

ASIC is making inquiries of four entities concerning their accounting for income tax and, in particular, the substantiation of their tax expense positions. This includes where:
- there is no apparent reason why the tax expense is low having regard to reported profit, and necessary disclosures have not been made
- where temporary differences and deferred tax balances appear to have arisen from non-ongoing transactions, and
- there are unusual reconciling items between accounting profit and tax expense/benefit that result in significant tax benefits.

We are also making inquiries of three entities as to whether it is probable that future taxable income will be sufficient to enable the recovery of deferred tax assets relating to tax losses.

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4. Amortisation of intangible assets

ASIC is making inquiries of four entities concerning the appropriateness of their assessment of indefinite useful life and/or the amortisation periods attributed to intangibles.

Amortisation should take place as the benefits of an intangible asset are consumed by the entity, which may differ from the periods over which revenue is expected to be generated by the asset. Where the useful life of an intangible asset arises from contractual or legal rights the amortisation period must not exceed the period of the contractual or legal rights. Useful life extends to the contract term, including renewal periods where renewal is expected to occur and renewal costs are not significant.

5. Expense deferral

Expenses should only be deferred where there is an asset as defined in the accounting standards and it is probable that future economic benefits will arise. We are making inquiries of two entities in relation to the deferral of expenditure to the balance sheet. Particular concerns include recognition of intangible assets arising from the development phase where the strict criteria for deferral do not appear to be met.

6. Revenue recognition

ASIC is following up one matter concerning the recognition of revenue. We continue to see instances where the disclosure of revenue recognition policies by some entities was not sufficiently specific to the entity, its business and sources of revenue. Boilerplate accounting policies do not assist users of a financial report to understand the basis of revenue recognition, particularly where business models are more complex and there are multiple sources of revenues.

7. Estimates and accounting policy judgements

We observed instances where entities needed to improve the quality and completeness of disclosures in relation to judgements, key assumptions, estimation uncertainties, and significant judgments in applying accounting policies.

Disclosures in this area are important to allow users of the financial report to assess the reported financial position and performance of an entity with all relevant information.

(continued)

Figure 1.6 *(continued)*

8. Disclosure in the operating and financial review (OFR)
ASIC Regulatory Guide 247 *Effective disclosure in an operating and financial review* (RG 247) was released in March 2013 to assist directors of listed entities in providing useful and meaningful analysis and information in the OFR as required by law. We have continued to see significant improvements in the quality of OFRs as a result of our reviews.

We have continued to see a substantial reduction in instances where entities sought to rely on an exemption for information that could cause unreasonable prejudice and did not disclose any information on business strategies and prospects for future financial years.

We remind entities to continue to refer to RG 247 and review how best to articulate their business model, strategies, and underlying drivers of financial performance.

9. Segment reporting
We are still finding some entities that do not appear to have met the core principle in AASB 8 *Operating segments*, and disclosed segment information that may be important to investors. This includes some entities that provide select segment information in market announcements and other documents but don't disclose segment information in their financial reports. We are making enquiries of three entities in relation to their operating segment disclosures.

10. Non-IFRS financial information
Our reviews continue to show that entities are following the guidance in ASIC Regulatory Guide 230 *Disclosing non-IFRS financial information* (RG 230).

11. Other areas
ASIC is also making enquiries of entities in relation to the following matters.
- the classification of instruments as equity rather than liabilities;
- the appropriateness of applying the going concern assumption; and
- possible under recorded provisions.

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1.2.4 Australian Prudential Regulation Authority (APRA)

The **Australian Prudential Regulation Authority (APRA)** is the prudential regulator of the Australian financial services industry. It oversees:
- banks
- credit unions
- building societies
- general insurance and reinsurance companies
- life insurance
- friendly societies
- most members of the superannuation industry.

APRA identifies the key risks taken by an entity, ensures the risks are adequately measured, managed and monitored, and assesses the adequacy of the entity's financial resources to accommodate potential losses. The aim of APRA's supervision is to promote financial stability by requiring these institutions to manage risk prudently so as to minimise the likelihood of financial losses to depositors, policy holders and superannuation fund members.

Regulated entities provide financial and other information to APRA. Summary statistics, such as monthly banking statistics, are reported by APRA. More information about the activities of APRA and its publications are provided on its website, www.apra.gov.au.

1.2.5 Australian Securities Exchange Group (ASX)

The Australian Stock Exchange Ltd was formed in 1987 through the amalgamation of six independent stock exchanges that formerly operated in Australia. In 2006, the Australian Stock Exchange merged with the Sydney Futures Exchange and operated under the name 'Australian Securities Exchange'. Following a restructure, the name Australian Securities Exchange Group (ASX) was adopted from 1 August 2010.

The ASX operates the largest securities market in Australia. Several of its functions have implications for financial reporting practice. As discussed in section 1.1.4, the ASX establishes Listing Rules for entities that offer securities on its exchange. The ASX oversees compliance with its operating rules, promotes standards of corporate governance among Australia's listed companies and helps to educate retail investors. The ASX relies on a range of subsidiary brands to monitor and enforce compliance with its operating rules. These subsidiaries are as follows.
- Australian Securities Exchange — which handles ASX's primary, secondary and derivative market services. It encompasses ASX (formerly Australian Stock Exchange) and ASX 24 (formerly Sydney Futures Exchange).

- ASX Clearing Corporation — the brand under which ASX's clearing services are promoted. It encompasses ASX Clear (formerly the Australian Clearing House) and ASX Clear (Futures) (formerly SFE Clearing Corporation).
- ASX Settlement Corporation — the brand under which ASX Group's settlement services are promoted. It encompasses ASX Settlement (formerly ASX Settlement and Transfer Corporation) and Austraclear.
- ASX Compliance — the brand under which services are provided to the ASX Group for the ongoing monitoring and enforcement of compliance with the ASX operating rules. This entity replaces ASX Markets Supervision.

More information about the ASX can be obtained from its website, www.asx.com.au.

LEARNING CHECK

- ☐ The key players in standard setting in Australia are the Financial Reporting Council (FRC) and the AASB. Other key players in financial reporting regulation include the Australian Securities and Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) and the Australian Securities Exchange Group (ASX).
- ☐ The FRC provides broad oversight of the accounting standard-setting process in Australia.
- ☐ The AASB formulates and issues accounting standards in Australia.
- ☐ ASIC is the regulator of corporations, markets and financial services.
- ☐ APRA regulates the financial services industry, overseeing banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies and most members of the superannuation industry.
- ☐ The ASX operates the largest securities market in Australia and maintains a set of rules for entities that list on its exchange.

1.3 The International Accounting Standards Board (IASB)

LO 3
Explain the structure, role and processes of the International Accounting Standards Board (IASB) and the IFRS Interpretations Committee (IFRIC)

Following the direction of the FRC, Australia adopted accounting standards issued by the **International Accounting Standards Board (IASB)** commencing on or after 1 January 2005. The IASB is an independent standard-setting board that develops and approves International Financial Reporting Standards (IFRSs). The IFRS Interpretations Committee (formerly known as International Financial Reporting Interpretations Committee) issues interpretations (IFRICs) and guidance for accounting standards and for specific transactions or events. Compliance with IFRSs includes compliance with IFRICs. The IASB and IFRS Interpretations Committee are appointed and overseen by a geographically and professionally diverse group of trustees (IFRS Foundation Trustees) who are publicly accountable to a monitoring board comprising public capital market authorities. The IFRS Foundation Trustees appoint an IFRS Advisory Council, which provides strategic advice to the IASB and informs the IFRS Foundation Trustees. The Trustees are accountable to the Monitoring Board, which comprises public authorities including the International Organization of Securities Commissions.

Available on the IASB website is a document titled *IFRS Foundation and International Accounting Standards Board (IASB): Who we are and what we do*. Further information about the IASB and international standard-setting arrangements is also available on the IASB website, www.ifrs.org.

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LEARNING CHECK

- ☐ The IASB is responsible for the development and publication of IFRSs, which are adopted in Australia as AASBs.

1.4 The components of the conceptual framework

LO 4
Explain the key components of the conceptual framework

The role of a conceptual framework of accounting is to provide guidance to standard setters in developing accounting standards and to guide preparers on accounting issues that are not addressed by accounting standards. In 1989, the International Accounting Standards Committee (IASC), the predecessor to the IASB, adopted the *Framework for the Preparation and Presentation of Financial Statements*. This document was superseded by the *Conceptual Framework for Financial Reporting* in 2010. The IASB's conceptual framework comprises four chapters:

- Chapter 1: the objective of general purpose financial reporting
- Chapter 2: the reporting entity (to be added by the IASB)
- Chapter 3: the qualitative characteristics of useful financial reporting
- Chapter 4: the *Framework* (1989): the remaining text (comprising underlying assumption, definition and recognition of elements of financial statements, measurement and concepts of capital and capital maintenance).

The IASB is currently involved in a joint project with the FASB in the United States to revise the conceptual framework. Several phases of this project are complete, including the objectives of financial reporting and the qualitative characteristics of financial information. Further development is continuing on other stages of the project, including the reporting entity concept, definitions of elements of financial statements, and measurement.

At the time of writing, the AASB has retained its existing *Framework for the Preparation and Presentation of Financial Statements* in anticipation of further revisions to the IASB's conceptual framework. It issued *Amendments to the Australian Conceptual Framework* in December 2013 to incorporate the IASB's Chapters 1 and 3 as

an Appendix to the *Framework for the Preparation and Presentation of Financial Statements*. Thus, at the time of writing, the Australian conceptual framework comprises:

- the *Framework for the Preparation and Presentation of Financial Statements*
- SAC 1 *Definition of the Reporting Entity,* issued in August 1990. This document contained a number of key concepts. In particular, it raised the classification of financial statements into general purpose financial statements and special purpose financial statements. For a financial statement to be classed as general purpose, it had to be prepared in accordance with Statements of Accounting Concepts and accounting standards. The other key contribution of SAC 1 was the definition of a 'reporting entity' as an entity 'in respect of which it is reasonable to expect the existence of users dependent on general purpose financial statements for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources'. This definition was to be crucial in determining which entities in Australia should be required to prepare general purpose financial statements.

Even though the title of the Australian conceptual framework is different from the IASB's, the contents are compatible. They will be discussed in following sections.

1.4.1 The objective of financial reporting

The conceptual framework deals only with the objective of general purpose financial statements; that is, financial statements intended to meet the information needs common to a range of users who are unable to command the preparation of reports tailored to satisfy their own particular needs.

Paragraph OB2 of the conceptual framework states:

> 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. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

This objective reflects several value judgements made by the IASB and the FASB about the role of financial statements, which are described in the *Basis for Conclusions on Chapter 1: The objective of general purpose financial reporting*. The Basis for Conclusions includes the following arguments.

- Financial statements should reflect the perspective of the entity rather than the perspective of the entity's equity investors. The focus is then on the entity's resources and the changes in them rather than on the shareholders as owners of the entity. Shareholders are providers of resources as are those who provide credit resources to the entity. Under the entity perspective, the reporting entity is deemed to have substance of its own, separate from that of its owners (paragraph BC1.8).
- The key users of financial statements are capital providers — existing and potential investors, lenders and other creditors. An entity obtains economic resources from capital providers in exchange for claims on those resources. Because of these claims, capital providers have the most critical and immediate need for economic information about the entity. These parties also have common information needs. The focus on these users of information, as opposed to other potential users such as government, regulatory bodies, employees and customers is a narrowing of the user groups in comparison to the groups considered in the former version of the IASB conceptual framework (paragraphs BC1.9–1.12).

Before the objective of general purpose financial reporting can be implemented in practice, the basic qualitative characteristics of financial reporting information need to be specified. Further, it is necessary to define the basic elements — assets, liabilities, equity, income and expenses — used in financial statements.

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1.4.2 The reporting entity

Chapter 2 of the conceptual framework is reserved for the reporting entity. The IASB and FASB are undertaking a joint project to determine what constitutes a reporting entity for the purposes of general purpose financial reporting. In March 2010, the IASB released an exposure draft titled *Exposure Draft ED/2010/2 Conceptual Framework for Financial Reporting — The Reporting Entity,* with comments due to be received by 16 July 2010. At the time of writing, this phase of the conceptual framework project was on hold until such time as the IASB made its agenda decisions regarding its future work plans. Given that Chapter 2 of the conceptual framework is yet to be finalised, the AASB's SAC 1 *Definition of the Reporting Entity* remains applicable (see section 1.1.2). Further information about the developments on this phase of the conceptual framework project can be found on the project web page, www.fasb.org/project/cf_phase-d.shtml.

LEARNING CHECK

- ☐ The conceptual framework applicable in Australia includes *The Framework for the Preparation and Presentation of Financial Statements*, which incorporates the IASB's *Conceptual Framework for Financial Reporting*, and SAC 1 *Definition of the Reporting Entity*.

1.5 Qualitative characteristics of useful information

LO 5
Explain the qualitative characteristics that make information in financial statements useful

What characteristics should financial information have in order to be included in general purpose external financial statements? The following discusses both the qualitative characteristics of useful information and the constraint on providing useful information. The qualitative characteristics are divided into fundamental qualitative characteristics and enhancing qualitative characteristics.

1.5.1 Fundamental qualitative characteristics

For financial information to be decision useful, it must possess two fundamental qualitative characteristics:
- relevance
- faithful representation.

Relevance

Paragraphs QC6 to QC11 of the conceptual framework elaborate on the qualitative characteristic of **relevance**. Information is relevant if:

- it is capable of making a difference in the decisions made by the capital providers as users of financial information
- it has predictive value, confirmatory value or both. Predictive value occurs where the information is useful as an input into the users' decision models and affects their expectations about the future. Confirmatory value arises where the information provides feedback that confirms or changes past or present expectations based on previous evaluations.
- it is capable of making a difference whether the users use it or not. It is not necessary that the information has actually made a difference in the past or will make a difference in the future.

Information about the financial position and past performance is often used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as future dividends and wage payments, future share prices, and the ability of the reporting entity to pay its debts when they fall due. The predictive ability of information may be improved if unusual or infrequent transactions and events are reported separately in the statement of comprehensive income.

Materiality is an entity-specific aspect of the relevance of information. Information is **material** if its omission or misstatement could influence the decisions that users make about a specific reporting entity (paragraph QC11).

Small expenditures for non-current assets (e.g. tools) are often expensed immediately rather than depreciated over their useful lives to save the clerical costs of recording depreciation, and because the effects on performance and financial position measures over their useful lives are not large enough to affect decisions. Another example of the application of materiality is the common practice by large companies of rounding amounts to the nearest thousand dollars in their financial statements.

Materiality is a relative matter — what is material for one entity may be immaterial for another. A $10 000 error may not be important in the financial statements of a multimillion-dollar company, but it may be critical to a small business. The materiality of an item may depend not only on its relative size but also on its nature. For example, the discovery of a $10 000 bribe is a material event even for a large company. Judgements as to the materiality of an item or event are often difficult. Accountants make judgements based on their knowledge of the company and on past experience, and users of financial statements must generally rely on the accountants' judgements.

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Faithful representation

Paragraphs QC12 to QC16 of the conceptual framework elaborate on the concept of faithful representation. **Faithful representation** is attained when the economic phenomenon is depicted completely, neutrally and free from material error. This results in the depiction of the economic substance of the underlying transaction. Note the following in relation to these characteristics.
- A depiction is *complete* if it includes all information necessary for faithful representation.
- *Neutrality* is the absence of bias intended to attain a predetermined result. Providers of information should not influence the making of a decision or judgement to achieve a predetermined result.
- As information is provided under conditions of uncertainty and judgements must be made, there is not necessarily certainty about the information provided. It may be necessary to disclose information about the degree of uncertainty in the information in order that the disclosure attains faithful representation.

As explained in paragraph BC3.23 of the *Basis for Conclusions on Chapter 3: Qualitative Characteristics of Useful Financial Information,* the boards noted that there are a variety of notions as to what is meant by reliability. The boards believe that the term faithful representation provides a better understanding of the quality of information required (paragraph BC3.24).

The two fundamental qualitative characteristics of financial information may give rise to conflicting guidance on how to account for phenomena. For example, the measurement base that provides the most relevant information about

an asset will not always provide the most faithful representation. The conceptual framework (paragraphs QC17–QC18) explains how to apply the fundamental qualitative characteristics. Once the criterion of relevance is applied to information to determine which economic information should be contained in the financial statements, the criterion of faithful representation is applied to determine how to depict those phenomena in the financial statements. The two characteristics work together. Either irrelevance (the economic phenomenon is not connected to the decision to be made) or unfaithful representation (the depiction is not decision useful) results in information that is not decision useful.

1.5.2 Enhancing qualitative characteristics

The conceptual framework (paragraph QC19) identifies four enhancing qualitative characteristics:
- comparability
- verifiability
- timeliness
- understandability.

These characteristics are *complementary* to the fundamental characteristics. The enhancing characteristics distinguish *more useful* information from *less useful* information. In relation to these enhancing qualities, note the following.
- **Comparability** is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. Making decisions about one entity may be enhanced if comparable information is available about similar entities; for example, profit for the period per share.
- **Verifiability** is a quality of information that helps assure users that information faithfully represents the economic phenomena that it purports to represent. Verifiability is achieved if different independent observers could reach the same general conclusions that the information represents the economic phenomena or that a particular recognition or measurement model has been appropriately applied.
- **Timeliness** means having information available to decision makers before it loses its capacity to influence decisions. If such capacity is lost, then the information loses its relevance. Information may continue to be timely after it has been initially provided, for example, in trend analysis.
- **Understandability** is the quality of information that enables users to comprehend its meaning. Information may be more understandable if it is classified, characterised and presented clearly and concisely. Users of financial statements are assumed to have a reasonable knowledge of business and economic activities and to be able to read a financial report.

Alternative accounting policies exist in the treatment of many items, such as inventories and cost of sales, non-current assets and depreciation, intangible assets (e.g. patents, copyrights and goodwill), and leasing transactions. The standard setters have expressed their position regarding the consistency of accounting methods in accounting standard AASB 108/IAS 8, which states that an entity must select and apply its accounting policies in a consistent manner from one period to another. Consistency of practices between entities is also desired. Any change made in an accounting policy by an entity must be disclosed by stating the nature of the change, the reasons the change provides reliable and more relevant information, and the effect of the change in monetary terms on each financial statement item affected. For example, a change in policies may be disclosed in a note such as this:

> During the year, the company changed from the first-in first-out to the weighted average cost method of accounting for inventory because the weighted average cost method provides a more relevant measure of the entity's financial performance. The effect of this change was to increase cost of sales by $460 000 for the current financial year.

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Note that the need for consistency does not require a given accounting method to be applied throughout the entity. An entity may very well use different methods for different types of inventories and different depreciation methods for different kinds of non-current assets. (Different inventories costing and depreciation methods are discussed in chapters 4 and 5.) Furthermore, the need for consistency should not be allowed to hinder the introduction of better accounting methods. Consistency from year to year or entity to entity is not an end in itself, but a means for achieving greater comparability in the presentation of information in general purpose financial statements. The need for comparability should not be confused with mere uniformity or consistency. It is not appropriate for an entity to continue to apply an accounting policy if the policy is not in keeping with the qualitative characteristics of relevance and faithful representation.

1.5.3 Cost constraint on useful financial reporting

Paragraphs QC35 to QC37 of the conceptual framework note that cost is the constraint that limits the information provided by financial reporting. The provision of information incurs costs. The benefits of supplying information should always be greater than the costs. Costs include costs of collecting and processing information, costs of verifying information, and costs of disseminating information. The non-provision of information also imposes costs on the users of financial information as they seek alternative sources of information.

LEARNING CHECK

- ☐ To be useful for decision making, financial information must be relevant and faithfully represent the economic phenomena.
- ☐ Accounting information is more useful when it possesses comparability, verifiability, timeliness and understandability.
- ☐ The provision of accounting information is constrained by the cost of providing that information.

1.6 Going concern assumption

LO 6 Discuss the going concern assumption underlying the preparation of financial statements

Paragraph 23 of the conceptual framework states that financial statements are prepared under the assumption that the entity will continue to operate for the foreseeable future. This assumption is called the **going concern assumption** or sometimes the *continuity assumption*. Past experience indicates that the continuation of operations in the future is highly probable for most entities. Thus, it is assumed that an entity will continue to operate at least long enough to carry out its existing commitments.

Adoption of the going concern assumption has important implications in accounting. For example, it is an assumption used by some to justify the use of historical costs in accounting for non-current assets and for the systematic allocation of their costs to depreciation expense over their useful lives. Because it is assumed that the assets will not be sold in the near future but will continue to be used in operating activities, current market values of the assets are sometimes assumed to be of little importance. If the entity continues to use the assets, fluctuations in their market values cause no gain or loss, nor do they increase or decrease the usefulness of the assets. The going concern assumption also supports the inclusion of some assets, such as prepaid expenses and acquired goodwill, in the statement of financial position even though they may have little, if any, sales value.

If management intends to liquidate the entity's operations, the going concern assumption is set aside and financial statements are prepared on the basis of expected liquidation (forced sale) values. Thus, assets are reported at their expected sales values and liabilities at the amount needed to settle them immediately. Paragraph 25 of AASB 101/IAS 1 *Presentation of Financial Statements* details disclosures required when an entity does not prepare financial statements on a going concern basis (see chapter 16).

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LEARNING CHECK

- ☐ Financial statements are prepared under the going concern assumption; that is, the assumption that an entity will continue to operate for the foreseeable future.

1.7 Definition of the elements of financial statements

LO 7 Define the basic elements in financial statements — assets, liabilities, equity, income and expenses

The conceptual framework identifies and defines the elements of financial statements: assets, liabilities, equity, income and expenses.

1.7.1 Assets

An **asset** is defined in paragraph 49(a) of the conceptual framework 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 essential characteristics of an asset, as follows.

1. The resource must contain *future economic benefits*; that is, it must have the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. An asset can cause future economic benefits to flow to the entity in a number of ways:
   - it can be exchanged for another asset
   - it can be used to settle a liability
   - it can be used singly or in combination with other assets to produce goods or services to be sold by the entity.
2. The entity must have *control* over the future economic benefits in such a way that the entity has the capacity to benefit from the asset in the pursuit of the entity's objectives, and can deny or regulate the access of others to those benefits.
3. There must have been a *past event*; that is, an event or events giving rise to the entity's control over the future economic benefits must have occurred.

An asset may have other characteristics, but the conceptual framework does not consider them essential for an asset to exist. For instance, assets are normally acquired at a cost incurred by the entity, but it is not essential that a cost is incurred in order to determine the existence of an asset. Similarly, it is not essential that an asset is tangible, that is, has a physical form (see paragraph 56 of the conceptual framework). Assets such as brands, copyrights and patents

represent future economic benefits without the existence of any physical substance. Such assets may be classified as intangible assets. Furthermore, assets can be exchanged normally for other assets, but this does not make exchangeability an essential characteristic of an asset. Finally, it is not essential that an asset is legally owned by the reporting entity. Control by the entity often results from legal ownership, but the absence of legal rights or ownership does not preclude the existence of control, for example, a lease (see paragraph 57 of the conceptual framework).

1.7.2 Liabilities

A **liability** is defined in paragraph 49(b) of the conceptual framework as:

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

There are a number of important aspects concerning this definition, as follows.

- A legal debt constitutes a liability, but a liability is not restricted to being a legal debt. Its essential characteristic is the existence of a *present obligation,* being a duty or responsibility of the entity to act or perform in a certain way. A present obligation may arise as an obligation imposed by notions of equity or fairness (referred to as an 'equitable' obligation), and by custom or normal business practices (referred to as a 'constructive' obligation), as well as those resulting from legally enforceable contracts. For example, an entity may decide as a matter of policy to rectify faults in its products even after the warranty period has expired. Hence, the amounts that are expected to be spent in respect of goods already sold are liabilities. It is not sufficient for an entity merely to have an intention to sacrifice economic benefits in the future.

  A present obligation needs to be distinguished from a future commitment. A decision by management to buy an asset in the future does not give rise to a present obligation. An obligation normally arises when the asset is delivered, or the entity has entered into an irrevocable agreement to buy the asset, with a substantial penalty if the agreement is revoked.
- A liability must be expected to be settled, thus resulting in the *giving up of resources* embodying economic benefits. The entity must have little, if any, discretion in avoiding this sacrifice. This settlement in the future may be required on demand, at a specified date, or when a specified event occurs. Thus, a guarantee under a loan agreement is regarded as giving rise to a liability in that a sacrifice is required when a specified event occurs, for example, default under the loan.

  Settlement of a present obligation may occur in a number of ways:
  - by paying cash
  - by transferring other assets
  - by providing services
  - by replacing that obligation with another obligation
  - by converting that obligation to equity
  - by a creditor waiving or forfeiting his or her rights.
- A final characteristic of a liability is that it must have resulted from a *past transaction* or event. For example, the acquisition of goods and the work done by staff give rise to accounts payable and wages payable respectively. Wages to be paid to staff for work they will do in the future is not a liability as there is no past transaction or event and no present obligation.

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1.7.3 Equity

Paragraph 49(c) of the conceptual framework defines **equity** as:

> the residual interest in the assets of the entity after deducting all its liabilities.

Defining equity in this manner shows clearly that it cannot be defined independently of the other elements in the statement of financial position. The characteristics of equity are as follows.

- Equity is a residual, that is, something left over. In other words:

$$\text{Equity} = \text{Assets} - \text{Liabilities}$$

- Equity increases as a result of profitable operations (i.e. the excesses of income over expenses) and by contributions by owners. Similarly, equity is diminished by unprofitable operations and by distributions to owners (drawings and dividends).
- Equity is influenced by the measurement system adopted for assets and liabilities and by the concepts of capital and capital maintenance adopted in the preparation of general purpose external financial statements. (These aspects are discussed later in the chapter.)
- Equity may be subclassified in the statement of financial position; for example, into contributed funds from owners, retained earnings, other reserves representing appropriations of retained earnings, and reserves representing capital maintenance adjustments.

1.7.4 Income

The conceptual framework defines **income** in paragraph 70(a) 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.

Note that this definition of income is linked to the definitions of assets and liabilities. The definition of income is wide in its scope, in that income in the form of inflows or enhancements of assets can arise from providing goods or services, investing in or lending to another entity, holding and disposing of assets, and receiving contributions such as grants and donations. To qualify as income, the inflows or enhancements of assets must have the effect of increasing equity, excluding capital contributions by owners. Also excluded are certain increases in equity under various inflation accounting models that require the recognition of capital maintenance adjustments.

Another important aspect of the definition is that, if income arises as a result of an increase in economic benefits, it is necessary for the entity to *control* that increase in economic benefits. If control does not exist, then no asset exists. Income arises once control over the increase in economic benefits has been achieved and an asset exists, provided there is no equivalent increase in liabilities. For example, in the case of magazine subscriptions received in advance, no income exists on receipt of the cash because an equivalent obligation also has arisen for services to be performed through supply of magazines to clients in the future.

Income can also exist through a reduction in liabilities that increase the entity's equity. An example of a liability reduction is if a liability of the entity is 'forgiven'. Income arises as a result of that forgiveness, unless the forgiveness of the debt constitutes a contribution by owners.

Under the conceptual framework, income encompasses both revenue and gains. A definition of **revenue** is contained in paragraph 7 of AASB 118/IAS 18 *Revenue*:

> the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Thus revenue represents income which has arisen from 'the ordinary activities of an entity'. On the other hand, *gains* represent income that does not necessarily arise from the ordinary activities of the entity; for example, gains on the disposal of non-current assets or on the revaluation of marketable securities. Gains are usually disclosed in the statement of profit or loss and other comprehensive income net of any related expenses, whereas revenues are reported at a gross amount. As revenues and gains are both income, there is no need to regard them as separate elements under the conceptual framework.

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1.7.5 Expenses

Paragraph 70(b) of the conceptual framework contains the following definition of **expenses**.

> Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

To qualify as an expense, a reduction in an asset or an increase in a liability must have the effect of decreasing the entity's equity. The purchase of an asset does not decrease equity and therefore does not create an expense. An expense arises whenever the economic benefits in the asset are consumed, expire or are lost. Like income, the definition of expenses is expressed in terms of changes in assets, liabilities and equity. This concept of expense is broad enough to encompass items that have typically been reported in financial statements as 'losses'; for example, losses on foreign currency transactions, losses from fire or flood, or losses on the abandonment of a research project. Losses are expenses that may not arise in the ordinary course of the entity's activities.

LEARNING CHECK

- ☐ The conceptual framework identifies and defines the elements of financial statements: assets, liabilities, equity, income and expenses.
- ☐ An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- ☐ A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- ☐ Equity is the residual interest in the assets of the entity after deducting all its liabilities.
- ☐ Income is defined 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.
- ☐ Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

LO 8
Explain the principles for recognising the elements of financial statements

1.8 Recognition of the elements of financial statements

There are recognition criteria to be followed in the preparation and presentation of financial statements in practice. These criteria have been set down as part of the conceptual framework. **Recognition** means the process of incorporating into the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element. In other words, it involves the inclusion of dollar amounts in the entity's accounting system. Note that an item must satisfy the definition of an element and the recognition criteria before it is 'recognised'.

1.8.1 Asset recognition

The conceptual framework states in paragraph 89 that an asset should be recognised in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or other value that can be measured reliably. Here, emphasis is placed on criteria for determining *when to record* an asset in the entity's accounting records. An asset is to be recognised only when both the probability and the reliable measurement criteria are satisfied. The term 'probability' refers to the degree of certainty that the future economic benefits will flow to the entity. The benefits should be more likely rather than less likely. For example, some development costs are not recognised as an asset because it is not 'probable' that future economic benefits will eventuate.

Even if such probability of future benefits is high, recognition of an asset cannot occur unless some cost or other value is capable of reliable measurement. In practice, reliable measurement of internally generated goodwill has been difficult, and therefore such goodwill has not been recognised as an asset. Similarly, reliable measurement of an entity's mineral reserves is difficult. It is argued in the conceptual framework that assets that cannot be measured reliably may nevertheless be disclosed in notes to the financial statements, particularly if knowledge of the item is considered relevant to evaluating the entity's financial position, performance and cash flows.

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1.8.2 Liability recognition

Paragraph 91 of the conceptual framework establishes criteria for the recognition of a liability in an entity's accounting records. A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from settling the present obligation and the amount at which the settlement will take place can be measured reliably.

As with the recognition of assets, the concept of probability is concerned with the level of uncertainty that the outflow of economic benefits will be required to settle the obligation. The additional need for reliable measurement is an attempt to measure, in monetary terms, the amount of economic benefits that will be sacrificed to satisfy the obligation. Any liabilities that are not recognised in the accounting records because they do not satisfy the recognition criteria may be disclosed in notes to the financial statements, if considered relevant. Further discussion of the recognition of liabilities is provided in chapter 8.

1.8.3 Income recognition

In accordance with paragraphs 92 and 93 of the conceptual framework, income is recognised in the statement of profit or loss and other comprehensive income when an increase in future economic benefits relating to an increase in an asset or a decrease in a liability can be measured reliably. As with the recognition criteria for assets and liabilities, probability of occurrence and reliability of measurement are presented as the two criteria for income recognition. For many entities, the majority of income in the form of revenues results from the provision of goods and services during the reporting period. There is little uncertainty that the income has been earned since the entity has received cash or has an explicit claim against an external party as a result of a past transaction. However, the absence of an exchange transaction often raises doubts as to whether the income has achieved the required degree of certainty. In situations of uncertainty, the conceptual framework requires the income to be recognised as long as it is 'probable' that it has occurred and the amount can be measured reliably.

As stated previously, income includes both revenues and gains. The standard setters have provided further requirements for the recognition of revenues in accounting standard AASB 118/IAS 18 *Revenue*, which deals with the recognition of different types of revenue that can arise in an entity. The standard requires all revenue recognised in the entity's financial statements to be measured at the fair value of the consideration received or receivable. Separate recognition criteria are then provided for each different category of revenue. See chapter 15 for a detailed discussion of revenue recognition.

1.8.4 Expenses recognition

Just as the income recognition criteria have been developed in the conceptual framework as a guide to the timing of income recognition, the expense recognition criteria have been developed to guide the timing of expense recognition. The formulators of the conceptual framework view expenses in terms of decreases in future economic benefits in the form of reductions in assets or increases in liabilities of the entity (see the definition of expenses in section 1.7.5). In addition to the probability criteria for expense recognition, the conceptual framework states that expenses are recognised in the statement of profit or loss and other comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability can be measured reliably (paragraph 94). This means that an expense is recognised simultaneously with a decrease in an asset or an increase in a liability. An expense is also recognised in the statement of profit or loss and other comprehensive income when the entity incurs a liability without the recognition of any asset, for example, wages payable.

In years past, the process of recognising expenses was referred to as a 'matching process', whereby an attempt was made to associate each cost with the income recognised in the current period. Costs that were 'associated' with the revenue were then said to be 'matched' and written off to expenses. This idea of matching expenses with income has been dropped in the conceptual framework in favour of assessing the probability of a decrease in economic benefits that can be measured reliably. Matching is no longer the expense recognition criterion under the conceptual framework.

ILLUSTRATIVE EXAMPLE 1.3 | Asset recognition

Richie Ltd produces snowboards and ski gear in Victoria. It invested $15 million in researching new technology to enhance the stability of its snowboards. It also invested $10 million for a patent to develop the production of ski poles with new technologies purchased.

Should Richie Ltd recognise the research and development costs as assets?

To address this question, it is necessary to first consider whether the research and development costs meets the definition of an asset. If so, we must consider whether the recognition criteria are met.

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. In relation to the research cost, there is an uncertainty in future economic benefits to be generated for Richie Ltd. Hence it does not fulfill the definition of an asset and cannot be recognised as an asset of the company.

The development cost of ski poles will probably generate future economic benefits to the entity through increased future sales. The purchased of the registered patent on the new technologies (past event) gives the entity control over the future economic benefits. Hence, it fulfills the definition of an asset. Given that it is probable that future economic benefits will flow to the entity and the costs can be determined reliably, it meets the recognition criteria. Therefore, the development cost can be recognised as an asset of the company.

LEARNING CHECK

- ☐ An item or transaction must meet the definition of an element of financial statements and the recognition criteria stipulated in the conceptual framework to be included in financial statements.
- ☐ An asset should be recognised in the statement of financial position when it is probable that future economic benefits will flow to the entity and the asset has a cost or other value that can be measured reliably.
- ☐ A liability is recognised in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from settling the present obligation and the amount at which the settlement will take place can be measured reliably.
- ☐ Income is recognised in the statement of profit or loss and other comprehensive income when it is probable that there is an increase in future economic benefits relating to an increase in an asset or a decrease in a liability and the amount can be measured reliably.
- ☐ Expenses are recognised in the statement of profit or loss and other comprehensive income when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability can be measured reliably.

1.9 Measurement of the elements of financial statements

LO 9 Distinguish between alternative bases for measuring the elements of financial statements

Paragraph 99 of the conceptual framework describes the process of **measurement**:

> 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 [statement of financial position] and income statement [statement of profit or loss and other comprehensive income].

Because the concepts of equity, income and expenses are highly dependent on the concepts of assets and liabilities, measurement of the former depends on measurement of the latter. In other words, emphasis is placed

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on measuring assets and liabilities; the measurement of equity, income and expenses then follows. Measurement is very important in accounting in that it is the process by which valuations are placed on all elements reported in financial statements. Measurements thus have an important effect on the economic decisions made by users of those financial statements. The conceptual framework (paragraph 100) points out that a number of different measurement bases may be used for assets, liabilities, income and expenses in varying degrees and in varying combinations in financial statements. They include the following, the most common of which, in practice, is the historical cost basis.

- *Historical cost.* Under the *historical cost* measurement basis, an asset is recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire it at its acquisition date. Liabilities are recorded at the amount of the proceeds received in exchange for an obligation, or at the amount of cash to be paid out in order to satisfy the liability in the normal course of business.
- *Current cost.* For an asset, *current cost* represents the amount of cash or cash equivalents that would be paid if the same or equivalent asset was acquired currently. A liability is recorded at the amount of cash or cash equivalents needed to settle the obligation currently.
- *Realisable or settlement value.* For an asset, the *realisable value* is the amount of cash or cash equivalents that could be obtained currently by selling the asset in an orderly disposal, or in the normal course of business. A liability is measured as the amount of cash or cash equivalents expected to be paid to satisfy the obligation in the normal course of business.
- *Present value.* The present value of an asset means the discounted future net cash inflows or net cash savings that are expected to arise in the normal course of business. The *present value* of a liability is the discounted future net cash outflows that are expected to settle the obligation in the normal course of business.

In relation to measurement principles, the conceptual framework merely describes practice rather than establishing any principles that should be applied in the measurement of elements of financial statements. The measurement basis most commonly adopted by entities is the historical cost basis, although there is a trend towards greater use of fair values. For example, to comply with AASB 102/IAS 2 *Inventories,* inventories are to be measured at the lower of cost and net realisable value. The list is somewhat dated. There is little use of current cost (replacement cost) in financial statements. The omission of fair value reflects the need to revise and update this chapter of the conceptual framework. The use of *fair value*, which is defined as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date' (AASB 13/IFRS 13 *Fair Value Measurement* paragraph 9) is also referred to in many accounting standards.

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LEARNING CHECK

- ☐ 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 financial statements.
- ☐ Various measurement bases may be used for assets, liabilities, income and expenses: historical cost, current cost, realisable or settlement value, present value and fair value.

LO 10 Outline concepts of capital maintenance

1.10 Concepts of capital

Scant attention has been given to the concept of capital in accounting in the last 30 years, but it was a topic that received considerable focus during the current value debates of the 1960s to the early 1980s. It was argued then, and now, that before an entity can determine its income for any period, it must adopt not only a measurement basis for assets and liabilities but also a concept of capital. Two main concepts of capital are discussed in the conceptual framework, namely financial capital and physical capital.

Under the *financial capital* concept, capital is synonymous with the net assets or equity of the entity. It can be measured in two ways. It can be measured either in nominal monetary units by subtracting the total of liabilities from assets, or in terms of the purchasing power of the dollar amount recorded as equity. Profit exists only after the entity has maintained its capital, measured as either the dollar value of equity at the beginning of the period or the purchasing power of those dollars in the equity at the beginning of the period.

Under the *physical capital* concept, capital is seen not so much as the equity recorded by the entity but as the operating capability of the entity's assets. Profit exists only after the entity has set aside enough capital to maintain the operating capability of its assets. A number of different measurement systems have been devised in the past to provide alternatives to the conventional historical cost system, which is the system predominantly used in practice.

These alternatives, which represent different combinations of the measurement of assets and liabilities and the concept of capital maintenance, include:

- the *general price level accounting system*, which had its origins in Germany after World War I when inflation reached excessive levels — this system modifies the conventional historical cost system for the effects of inflation and therefore follows a financial capital concept
- *current value systems,* which attempt to measure the changes in the current values of assets and liabilities — these systems include measures of the current buying or input prices of net assets, and/or measures of the current selling or realisable values of net assets. Capital may be measured as either financial or physical.

LEARNING CHECK

- ☐ Two main concepts of capital are discussed in the conceptual framework: financial capital and physical capital.
- ☐ Under the financial capital concept, capital is synonymous with the net assets or equity of the entity. It can be measured either in terms of the actual number of calculated dollars by subtracting the total of liabilities from assets, or in terms of the purchasing power of the dollar amount recorded as equity.
- ☐ Under the physical capital concept, capital is seen as the operating capability of the entity's assets. Profit exists only after the entity has set aside enough capital to maintain the operating capability of its assets.

SUMMARY

This chapter has provided an overview of key sources of regulation of financial reporting. While the Corporations Act is an overriding authority, Australian accounting standards are a very important source of regulation of financial reporting. The requirements of specific Australian accounting standards are covered throughout this text. The adoption of IFRSs has increased the importance of developments in international standards setting for financial reporting in Australia.

The conceptual framework describes the basic concepts that underlie financial statements prepared in conformity with accounting standards. It serves as a guide to the standard setters in developing accounting standards and in resolving accounting issues that are not addressed directly in an accounting standard. The conceptual framework identifies the principal classes of users of an entity's general purpose financial statements and states that the objective of financial statements is to provide information — about the financial position, performance and changes in financial position of an entity — that is useful to existing and potential investors, lenders and other creditors, in making decisions about providing resources to the entity. It specifies the fundamental qualities that make financial information useful, namely relevance and faithful representation. The usefulness of financial information is enhanced by comparability, verifiability, timeliness and understandability, and constrained by cost.

The conceptual framework also defines the basic elements in financial statements (assets, liabilities, equity, income and expenses) and discusses the criteria for recognising them. The conceptual framework identifies alternative measurement bases used in practice and describes alternative concepts of capital maintenance.

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GLOSSARY

asset 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.

ASX Listing Rules The set of rules that the Australian Securities Exchange Group imposes on companies that list on the ASX.

Australian Prudential Regulation Authority (APRA) The Australian financial services industry regulator.

Australian Securities and Investments Commission (ASIC) The Australian corporate, markets and financial services regulator, responsible for administering the Corporations Act.

Australian Securities Exchange (ASX) Australia's principal securities exchange (and the company that operates it).

comparability The quality of information that enables users to identify similarities in and differences between two sets of economic phenomena.

Corporations Act The *Corporations Act 2001* is Australian Commonwealth legislation that covers many aspects of the operations of Australian companies, including requiring certain types of entities to prepare financial statements.

differential reporting The provision made in the Australian accounting standards for certain entities to adopt substantially reduced disclosures.

equity The residual interest in the assets of the entity after deducting all its liabilities.

expenses Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

faithful representation When an economic phenomenon is depicted completely, neutrally and free from material error.

Financial Reporting Council (FRC) The statutory body that oversees the accounting standard-setting process in Australia.

going concern assumption The assumption that the entity will continue to operate for the foreseeable future.

income 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.

International Accounting Standards Board (IASB) An independent international body that sets International Financial Reporting Standards (IFRSs).

International Financial Reporting Standards (IFRSs) Accounting standards issued by the International Accounting Standards Board (IASB).

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

material The quality of information that exists when the omission or misstatement of the information could influence the decision that users make.

measurement The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income.

recognition The process of incorporating into the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element.

relevance The quality of information that exists when the information influences economic decisions made by users.

reporting entity All entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general purpose financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources.

revenue The gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

timeliness The quality of information that exists when the information is presented before it loses its ability to influence decisions.

understandability The quality of information that exists when users are able to comprehend its meaning.

verifiability The quality of information that exists when different independent observers could reach the same general conclusions that the information represents the economic phenomena or that a particular recognition or measurement model has been appropriately applied.

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COMPREHENSION QUESTIONS

1. What are the key sources of regulation in Australia for a listed company?
2. Describe the standard-setting process of the AASB.
3. Distinguish between the roles of the FRC and the AASB.
4. How does the IASB influence financial reporting in Australia?
5. Explain the potential benefits and problems that can result from the adoption of IFRSs in Australia.
6. What is the difference between Australian accounting standards and IFRSs?
7. Specify the objectives of general purpose financial reporting, the nature of users, and the information to be provided to users to achieve the objectives as provided in the conceptual framework.
8. One of the functions of the FRC is to ensure that the Australian accounting standards are 'in the best interests of both the private and public sectors in the Australian economy'. How might they assess this?
9. Outline the fundamental qualitative characteristics of financial reporting information to be included in general purpose financial statements.
10. Discuss the importance of the going concern assumptions to the practice of accounting.
11. Discuss the essential characteristics of an asset as described in the conceptual framework.
12. Discuss the essential characteristics of a liability as described in the conceptual framework.
13. A government gives a parcel of land to a company at no charge. The company builds a factory on the land and employs people at the factory to produce jam that is sold in local and interstate markets. Considering the definition of income in the conceptual framework, do you think the receipt of the land is income to the company? Would your answer depend on how the land is measured?
14. Discuss the difference, if any, between income, revenue and gains.
15. Describe the qualitative characteristics of financial information according to the conceptual framework, distinguishing between fundamental and enhancing characteristics.
16. Define 'equity'. Explain why the conceptual framework does not prescribe any recognition criteria for equity.
17. In relation to the following multiple choice questions, discuss your choice of correct answer.
    (a) Which of the following statements about the conceptual framework is incorrect?
        (i) The conceptual framework considers timeliness and materiality to be constraints on relevant and reliable information.
        (ii) The conceptual framework states that the elements directly related to the measurement of financial position are assets, liabilities and equity.

(iii) The conceptual framework applies to the financial statements of all commercial, industrial and business reporting entities.
(iv) In accordance with the conceptual framework, income is recognised when an increase in future economic benefits related to an increase in an asset or a decrease in a liability has arisen that can be measured reliably.

(b) The conceptual framework's enhancing qualitative characteristics include:
(i) understandability, timeliness, verifiability and comparability
(ii) faithful representation, relevance, understandability and verifiability
(iii) comparability and reliability
(iv) substance over form and relevance.

(c) Which of the following statements about the conceptual framework's definition of expenses is correct?
(i) Expenses include distributions to owners.
(ii) Expenses are always in the form of outflows or depletions of assets.
(iii) Expenses exclude losses.
(iv) Expenses are always decreases in economic benefits.

(d) In accordance with the conceptual framework, a lender should recognise the forgiveness of its $20 000 interest-free loan as:
(i) an increase in income and a decrease in a liability
(ii) an increase in an expense and a decrease in an asset
(iii) an increase in an asset and an increase in income
(iv) an increase in an expense and a decrease in a liability.

CASE STUDIES

CASE STUDY 1.1

Visit the AASB website (www.aasb.gov.au) and find out the following.
(a) Who is the Chair of the AASB?
(b) Who are the members, and which organisations do they represent?
(c) Which accounting standards have been issued in the past year?
(d) Why are there differences in the numbering systems for current accounting standards (e.g. AASB x, AASB xxx and AASB xxxx)?
(e) What current projects (if any) is the AASB working on in cooperation with the IASB?

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CASE STUDY 1.2

Visit the website of the International Accounting Standards Board (www.ifrs.org) or the Financial Accounting Standards Board (www.fasb.org). Report on:
(a) the Joint Update Note from the IASB and FASB on Accounting Convergence April 2012 and the update of the remaining convergence projects in the meeting of the GZO Finance Ministers and Central Bank Governors in February 2013
(b) the accounting standards being changed as a result of moves towards international convergence
(c) the membership of the IASB and which countries the members come from
(d) the goals of the IASB.

CASE STUDY 1.3

Visit the website of the Australian Securities and Investments Commission (www.asic.gov.au). Report on:
(a) what ASIC is and its role
(b) the tips given to prospective shareholders regarding the reading of a company's prospectus
(c) the policy statements and practice notes issued by ASIC
(d) 'What's new' on the website.

CASE STUDY 1.4

Visit the website of the Financial Reporting Council (www.frc.gov.au). Locate its strategic plan and report on:
(a) the key purpose of the strategic plan 2013–16
(b) the four sources of complexity in financial reporting that the Managing Complexity in Financial Reporting Task Force outlined in its report to the FRC in May 2012.

STAR RATING
★ BASIC
★★ MODERATE
★★★ DIFFICULT

THRESHOLD LEARNING OUTCOMES FOR ACCOUNTING
K Knowledge AS Application Skills J Judgement
SM Self-Management CT Communication and Teamwork

APPLICATION AND ANALYSIS EXERCISES

K ★

Exercise 1.1 RELEVANT INFORMATION FOR AN INVESTMENT COMPANY

A year ago you bought shares in an investment company. The investment company in turn buys, holds and sells shares of business enterprises. You want to use the financial statements of the investment company to assess its performance over the past year.

(a) What financial information about the investment company's holdings would be most relevant to you?
(b) The investment company earns profits from appreciation of its investment securities and from dividends received. How would the concepts of recognition in the conceptual framework apply here?

K ★

Exercise 1.2 MEASURING INVENTORIES OF GOLD AND SILVER

AASB 102/IAS 2 *Inventories* allows producers of gold and silver to measure inventories of these commodities at selling price even before they have sold them, which means income is recognised at production. In nearly all other industries, however, income is recognised only when the inventories are sold to outside customers. What concepts in the conceptual framework might the standard setters have considered with regard to accounting for gold and silver production?

K J ★

Exercise 1.3 RECOGNISING A LOSS FROM A LAWSUIT

The law in your community requires store owners to shovel snow and ice from the pavement in front of their shops. You failed to do that, and a pedestrian slipped and fell, resulting in serious and costly injury. The pedestrian has sued you. Your lawyers say that while they will vigorously defend you in the lawsuit, you should expect to lose \$25 000 to cover the injured party's costs. A court decision, however, is not expected for at least a year. What aspects of the conceptual framework might help you in deciding the appropriate accounting for this situation?

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K J ★

Exercise 1.4 FINANCIAL STATEMENTS OF A REAL ESTATE INVESTOR

An entity purchases a rental property for \$10 000 000 as an investment. The building is fully rented and is in a good area. At the end of the current year, the entity hires an appraiser who reports that the fair value of the building is \$15 000 000 plus or minus 10%. Depreciating the building over 50 years would reduce the carrying amount to \$9 800 000.

(a) What are the relevance and faithful representation accounting considerations in deciding how to measure the building in the entity's financial statements?
(b) Does the conceptual framework lead to measuring the building at \$15 000 000? Or at \$9 800 000? Or at some other amount?

K J ★

Exercise 1.5 NEED FOR THE CONCEPTUAL FRAMEWORK VERSUS INTERPRETATIONS

Applying the conceptual framework is subjective and requires judgement. Would the IASB be better off to abandon the conceptual framework entirely and instead rely on a very active interpretations committee that develops detailed guidance in response to requests from constituents?

K AS ★

Exercise 1.6 MEANING OF 'DECISION USEFUL'

What is meant by saying that accounting information should be 'decision useful'? Provide examples.

K J ★

Exercise 1.7 PERFORMANCE OF A BUSINESS ENTITY

A financial analyst said:

> I advise my clients to invest for the long term. Buy good shares and hang onto them. Therefore, I am interested in a company's long-term earning power. Accounting standards that result in earnings volatility obscure long-term earning power. Accounting should report earning power by deferring and amortising costs and revenues.

Is this analyst's view consistent with the fundamental characteristics of financial information established in the conceptual framework?

Exercise 1.8 GOING CONCERN

K J ★

What measurement principles might be most appropriate for a company that has ceased to be a going concern (e.g. creditors have appointed a receiver who is seeking buyers for the company's assets)?

Exercise 1.9 ASSESSING PROBABILITIES IN ACCOUNTING RECOGNITION

K J ★

The conceptual framework defines an asset as a resource from which future economic benefits are expected to flow. 'Expected' means it is not certain, and involves some degree of probability. At the same time the conceptual framework establishes, as a criterion for recognising an asset, that 'it is probable that any future economic benefit associated with the item will flow to or from the entity.' Again, an assessment of probability is required. Is there a redundancy, or possibly some type of inconsistency, in including the notion of probability in both the asset definition and recognition criteria?

Exercise 1.10 PURCHASE ORDERS

K J ★

An airline places a non-cancellable order for a new aeroplane with one of the major commercial aircraft manufacturers at a fixed price, with delivery in 30 months and payment in full to be made on delivery.

(a) Under the conceptual framework, do you think the airline should recognise any asset or liability at the time it places the order?
(b) One year later, the price of this aeroplane model has risen by 5%, but the airline had locked in a fixed, lower price. Under the conceptual framework, do you think the airline should recognise any asset (and gain) at the time when the price of the aeroplane rises? If the price fell by 5% instead of rising, do you think the airline should recognise any liability (and loss) under the conceptual framework?

Exercise 1.11 DEFINITIONS OF ELEMENTS

K J CT ★

Explain how Q Ltd should account for the following items/situations, justifying your answer by reference to the conceptual framework's definitions and recognition criteria.

(a) Receipt of artwork of sentimental value only.
(b) Q Ltd is the guarantor for an employee's bank loan:
    (i) You have no reason to believe the employee will default on the loan.
    (ii) As the employee is in serious financial difficulties, you think it likely that he will default on the loan.
(c) Q Ltd receives 1000 shares in X Ltd, trading at $4 each, as a gift from a grateful client.
(d) The panoramic view of the coast from Q Ltd's café windows, which you are convinced attracts customers to the café.
(e) The court has ordered Q Ltd to repair the environmental damage it caused to the local river system. You have no idea how much this repair work will cost.

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Exercise 1.12 DEFINITIONS AND RECOGNITION CRITERIA

K J CT ★

Explain how T Ltd should account for the following items, justifying your answer by reference to the definitions and recognition criteria in the conceptual framework. Also state, where appropriate, which ledger accounts should be debited and credited.

(a) Photographs of the company's founders, which are of great sentimental and historical value.
(b) (i) T Ltd has been sued for negligence — likely it will lose the case.
    (ii) T Ltd has been sued for negligence — likely it will win the case.
(c) Obsolete plant now retired from use.
(d) T Ltd receives a donation of $10 000.

Exercise 1.13 DEFINITIONS AND RECOGNITION CRITERIA

K AS J ★

Glenelg Accounting Services has just invoiced one of its clients $3600 for accounting services provided to the client. Explain how Glenelg Accounting Services should recognise this event, justifying your answer by reference to relevant conceptual framework definitions and recognition criteria. Would your answer be different if the services had not yet been provided; that is, the payment is in advance?

K J CT ★

Exercise 1.14 ASSETS

Glam Cosmetics has spent $220 000 this year on a project to develop a new range of chemical-free cosmetics. As yet, it is too early for Glam Cosmetics' management to be able to predict whether this project will prove to be commercially successful. Explain whether Glam Cosmetics should recognise this expenditure as an asset, justifying your answer by reference to the conceptual framework asset definition and recognition criteria.

K J CT ★

Exercise 1.15 ASSET DEFINITION AND RECOGNITION

On 28 May 2016, $20 000 cash was stolen from Fremantle Ltd's night safe. Explain how Fremantle should account for this event, justifying your answer by reference to relevant conceptual framework definitions and recognition criteria.

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