https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

Chapter 2

The conceptual framework of accounting and its relevance to financial reporting

Review questions

2.1 A conceptual framework is a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards (FASB - see page 46). .

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

2.3 An entity becomes a reporting entity when users are said to exist who do not have access to information relevant to decision making and who are judged to be dependent on general purpose financial reports (GPFRs), the entity is deemed to be a reporting entity

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

Whether an entity is classified as a reporting entity is determined by the extent to which users (of financial information relating to that entity) have the ability to command the preparation of financial statements tailored to their particular information needs. Such a determination depends upon professional judgment. When information relevant to decision making is not otherwise accessible to users who are judged to be dependent upon general purpose financial statements to make and evaluate resource-allocation decisions, the entity is deemed to be a reporting entity. Where dependence is not readily apparent, factors that might indicate a reporting entity include the level of separation between management and owners and investors, the economic/political influence of the entity and the size of the entity in terms of its impact on employees, customers, suppliers etc.

2.4 The first conceptual framework started to emerge in America in the 1970s. This framework focused on providing a framework which would produce accounting standards that, in theory, supply investors with information for investment decisions. These decisions being whether to buy or sell shares in an entity. The FASB completed its framework in 1985 and in 1989 the IASC adopted the framework in its *Framework for the Preparation and Presentation of Financial Statements*. The aims of the Framework were to help the IASC develop new international standards, to review existing standards to reduce the number of alternative treatments allowed, and to assist national standard-setting bodies in developing standards consistent with international standards.

This Framework remained in place for many years but is currently being reviewed in a joint project by the IASB and the FASB. The first phase of the joint IASB/FASB initiative was completed in September 2010 and the IASB *Conceptual Framework* was amended. It was renamed to become the *Conceptual Framework for Financial Reporting*. The October 2010

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

revised version of the *Conceptual Framework* includes the first two chapters that the IASB has published as a result of its first phase of the conceptual framework project, these being:

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

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

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

Ideally we would have had a conceptual framework prior to the development of accounting standards as this may have enabled the development of accounting standards that are consistent with one another. Also, if there is agreement on certain fundamental and key issues then such issues would not need to be debated each time a new accounting standard is being developed. It is a costly process to develop a conceptual framework, and one which will require ongoing work. It should be noted that the development of the FASB's first conceptual framework was very slow. Many of the issues or building blocks shown in Figure 2.1 on page 54 remain to be addressed. From 2005 most European countries adopted the IASB Framework. Ongoing work is being undertaken by the IASB and the FASB to develop a joint conceptual framework to be used internationally and in 2010 amendments were made and a new component of the framework was released.

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

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

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

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

2.7 The IASB *Conceptual Framework* defines income as:

> *increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.*

The *Conceptual Framework* draws a distinction between 'revenues' and 'gains'. Income consists of *both* revenues and gains. Under the Conceptual Framework, 'revenue' arises in the course of the ordinary activities of an entity and is referred to by a variety of different names, including sales, fees, interest, dividends, royalties and rent. 'Gains' represent other items that meet the definition of income and might, or might not, arise in the course of the ordinary activities of an enterprise. Gains include, for example, those arising on the disposal of non-current assets or increases in the value of assets. Some gains, those that arose in the ordinary course of business are included in profit or loss and other unrealised gains, such as the upward revaluation of assets are included in 'other comprehensive income'. Some measure of professional judgment will be involved in determining whether a component of income should be classified as 'revenue' or as a 'gain'. Prior to 2005, within some countries in Europe, rather than referring to income reference was made to 'sales' and 'other income' and there was no statement of comprehensive income. Students should be encouraged to consider whether it is useful to subdivide income into revenues and gains.

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

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

2.9 According to the IASB *Conceptual Framework*, to be useful, financial information must not only represent relevant phenomena, but it must also 'faithfully represent' the phenomena that it purports to represent. According to paragraph QC 12 of the IASB *Conceptual Framework*:

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

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

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

QC14 A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

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

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

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

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

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

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

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

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

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

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

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

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

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

2.11 Directors must comply with accounting standards. Nevertheless, if directors believe that particular accounting standards are not appropriate, they have the option of highlighting this fact and explaining why. Specifically, paragraph 23 of IAS 1 *Presentation of Financials Statements* states:

> *In the extremely rare circumstances in which management concludes that compliance with a requirement in an International Financial Reporting Standard would be so misleading that it would conflict with the objective of financial statements set out in the Conceptual Framework, but the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:*
>
> *(a) the title of the International Financial Reporting Standard in question, the nature of the requirement, and the reason why management has concluded that complying*

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the Conceptual Framework; and

(b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a fair presentation.

As we can see from the above, IAS 1 includes a rebuttable presumption that if other entities in similar circumstances comply with the requirement, the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the IASB *Conceptual Framework*.

2.12 Previously, it was generally accepted that the IASB *Conceptual Framework* was not mandatory. However, accounting standards that have been adopted by the EU are and the inclusion of two paragraphs in Accounting Standard IAS 8 *Accounting Policies, Changes in Accounting Estimates, and Errors* has changed this position so that preparers of general purpose financial statements are now required to follow the IASB Framework. Specifically, paragraphs 10 and 11 of IAS 8 state:

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

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

(b) reliable, in that the financial statements:

(i) represent faithfully the financial position, financial performance and cash flows of the entity;

(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

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

(iv) are prudent; and

(v) are complete in all material respects.

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

(a) the requirements and guidance in International Financial Reporting Standards dealing with similar and related issues; and

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

Hence, the accounting standard IAS 8 requires management to refer to the IASB *Conceptual Framework* where a specific issue is not addressed in a particular accounting standard. That is, in the absence of a specific accounting standard to address an issue, reporting entities must be guided by the IASB *Conceptual Framework*.

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

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

technical experts, the Boards decided to consider the following working definition of an asset:

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

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

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

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

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

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

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

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

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

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

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

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

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

2.16 The elements of financial statements as per the Conceptual Framework are assets, liabilities, expenses, income and equity. See the text on pages 72 to 84 and the IASB *Conceptual Framework* for the definitions and recognition criteria of the various elements.

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

An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability.

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

A transaction or event needs also to be capable of *reliable measurement* before it is recognised for financial reporting purposes. This does not require that there must be certainty in relation to the measurement, because in practice there are many transactions

Copyright © 2013 McGraw-Hill Australia Pty Ltd

involving estimations that cannot be measured with certainty. For example, in determining the depreciation expense, the useful life of the asset needs to be estimated and this cannot be known with any degree of certainty. As another example, liability provisions are created for liabilities of uncertain timing and/or amount. As paragraph 11 of IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets* states, 'provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing of the amount of the future expenditure required in settlement'. Paragraph 36 of IAS 37 further states that the 'amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period'.

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

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

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

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

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

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

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

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

There is often a trade-off between relevance and representational faithfulness. For example, the earlier we can obtain the financial performance results of an entity, the more relevant the information will be in assessing that entity's performance. However, to increase the representational faithfulness of the data we might prefer to use financial information that has been the subject of an independent audit (therefore, for example, reducing the likelihood of error). The resultant increase in representational faithfulness, or reliability, will mean that

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

we will not receive the information for perhaps 10 weeks after the financial year end, at which point the information will not be quite as relevant because of its 'age'. Therefore, there can, in practice, be a matter of balancing one against the other. However if the data or information severely lacks one of the characteristics of relevance or faithful representation, then that information should not be provided to financial statement readers.

2.19 Pages 88 to 92 provide some criticisms of conceptual framework projects, such as the IASB *Conceptual Framework*. What must be remembered is that different parties will have different views about the need, or otherwise, for conceptual framework projects. Criticisms would include:

- The definitions of the elements of accounting—with the focus on such attributes as 'control'—tend to exclude the consideration of social costs and benefits generated by a reporting entity (arguably, of course, these are very difficult to measure).
- According to the IASB *Conceptual Framework*, the objective of general purpose financial reporting is to 'provide financial information about the reporting entity that is useful to existing and potential equity investors, lenders and other creditors in making decisions about providing resources to the entity'. Anybody who disagrees with the objective—upon which the *Conceptual Framework* is based—will then have problems accepting the balance of the Framework. If we were to believe that general purpose financial reports should also focus on providing information about an entity's ability to support various segments of the community or perhaps to support sustainability related initiatives then we would believe the focus of the Framework is too narrow.
- Linked to the above point, the determination of whether an entity is a reporting entity (and therefore required to produce general purpose financial statements) should primarily be dependent upon the existence of users who are dependent on general purpose financial statements for information to be used in making and evaluating economic decisions. By operating in the community, the company has a duty to provide information to people influenced by the organisation's activities, regardless of whether the interested parties are making resource allocation decisions.
- Conceptual frameworks simply reflect a codification of existing practice which tends to describe existing, rather than ideal, practice.
- Conceptual frameworks are used as a means of legitimising the ongoing existence of the accounting profession (that is, they prescribe characteristics such as objectivity).
- The IASB *Conceptual Framework* was very slow to develop.
- Specific to the IASB Framework, we have now replaced 'revenue' with 'income' as an element of financial statements. Income is to be broken down into 'gains' and 'revenue'. It is anticipated that it will not always be clear whether something should be classified as a 'gain' or 'income' and hence it is questionable whether such a dichotomy is of value.

2.20 Materiality is closely tied to the qualitative characteristic of relevance. The IASB *Conceptual Framework* states that:

> *Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or*

Copyright © 2013 McGraw-Hill Australia Pty Ltd

magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

Assessing materiality is very much a matter of judgment. Generally speaking, if an item of information is not deemed material (which is, of course, a matter of professional judgment), the mode of disclosure or even whether or not it is disclosed at all should not affect the decisions of financial statement readers.

Materiality, by definition, is therefore very economic in nature. Determining whether an item is material is not always a straightforward exercise and it is likely that different financial statement preparers will make different materiality assessments on various items.

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

Paragraph 7 of IAS 1 *Presentation of Financial Statements* states:

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor. Assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users.

Many accountancy firms provide guidance on materiality that relates to certain thresholds to their staff, for example a certain percentage of turnover, total assets or net income. Also the nature of the item is very important. For example, regardless of its size transactions with directors are deemed to be material due to their powerful position within the company and the agency potential that exists.

Challenging questions

2.21 It is generally assumed that financial statements are regarded as being true and fair if they have been properly prepared in accordance with accounting standards. The true and fair requirement is fundamental to accounting in the UK and in the EU for many years.

Note: The requirement that company and consolidated accounts give a true and fair view is recognised in Article 2 (3) of the 4th Company Law Directive and Article 16 (3) of the 7th Company Law Directive issued by the European Commission. Although these two Articles do not apply for accounts required to give a fair presentation in accordance with endorsed IFRS under the IAS Regulation, the true and fair principle underlying them is expressly

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

recognised in Article 3(2) of the IAS Regulation – no IFRS standard can be endorsed in the EU if it would conflict with the principle set out in those Articles.

However, s393 of the *Companies Act* 2006 enables directors to elect not to comply with an accounting standard if non-compliance is deemed necessary to create true and fair accounts. This is referred to as the 'true and fair override'. Indeed the legislation requires that companies do not approve financial statements unless satisfied that they give a true and fair view. The perspective taken is that in some isolated cases certain accounting standards might not be appropriate for a particular entity and application of the standards might actually make the financial statements misleading.

Numerous writers argued that as the true and fair view requirement is not clearly defined, directors could invoke the 'true and fair override' to justify not complying with particular accounting standards. Livne and McNichols (2009) conducted an empirical investigation into the use of the true and fair override by 1,141 UK companies over the period 1998 to 2002 (their analysis was restricted to 307 due to lack of a control sample). The authors ranked the types of override according to cost, wherein they classed overrides that have the greatest authoritative standing as being the most costly. For example, not complying with UK GAAP would have the highest cost as this is likely to cause conflict with auditors, potential intervention by regulatory bodies, and litigation as well as criticism by various market participants. The benefits may include being able to satisfy debt covenants. The authors suggest that an override is only likely to occur when the benefit outweighs the cost. A lesser cost is an override of UK law to comply with UK GAAP. The authors found that only 19% of the overrides were non-compliance with UK GAAP, the majority being non-compliance with UK law in favour of UK GAAP. The authors found that firms with weaker performance and lower interest coverage ratios are more likely to invoke the more costly override. This conflicts with the argument that the override results in financial statement that portray more true and fair view as successful companies would be equally as likely to invoke the override. This argument did not hold when the weaker override sample was examined. The most common overrides noted in the sample included not depreciating investment properties, goodwill measurement and amortisation and not showing grants amortised in deferred income.

2.22 According to the Conceptual Framework (paragraph QC11), an item is material if:

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

In addition, paragraph 7 of IAS 1 *Presentation of Financial Statements* states:

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.
Assessing whether an omission or misstatement could influence economic decisions of

Copyright © 2013 McGraw-Hill Australia Pty Ltd

users, and so be material, requires consideration of the characteristics of those users.
For financial statements to be considered true and fair, all information of a 'material' nature should be disclosed so that readers of the financial statements are not misled. However, 'materiality' is an assessment calling for a high degree of professional judgment. It is not possible to give a definition of 'material' that covers all circumstances.

When considering materiality in the context of the statement of financial position the amount of an item should be compared to the total asset or liability amount, the net asset figure and the total equity balance.
When considering materiality in the context of the statement of profit and loss/statement of comprehensive income comparison should be made to the net profit figure and the overall income or expense account to which the transaction/item related.
When considering materiality in the context of the statement of cash flows comparison should be made to the overall net cash flow from the particular heading to which the item/transaction relates (operating, investing or financing activity).
In all instances the nature of the item should also be considered.

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

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

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

2.24 An entity becomes a reporting entity when users are said to exist who do not have access to information relevant to decision making and who are judged to be dependent on general purpose financial reports (GPFRs), the entity is deemed to be a reporting entity.

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

Whilst the reporting entity concept is based on professional judgment, and perceptions about user needs, legislation provides a different approach to reporting providing tiered bands to legally classify entities as small, medium or large and this occurs whether they are public or private limited companies. Disclosure requirements also differ if the entity is public or private owned. Small private companies would typically not be considered to be reporting entities, as it is assumed that most people who require financial information about such an entity will be in a position to specifically demand it. Legislation as opposed to the *Conceptual Framework*, has more objective criteria for determining when a company is required to provide financial statements that comply with accounting standards. The European Commission (Department of Enterprise and Industry) and legislation such as the Companies Act 2006 set criteria that relate to measures such as gross income, value of total assets and number of employees. Specifically, a company is deemed to be a small private company, and therefore subject to fewer disclosure requirements than 'medium and large sized private companies' if it meets two or more of the following tests:

- Gross operating revenue for the financial year of less than £10 000 000.
- Gross assets at the end of the financial year of less than £10 000 000.
- Less than 50 full-time-equivalent employees.

Copyright © 2013 McGraw-Hill Australia Pty Ltd

https://manual-solution.com/downloads/accounting/solution-manual-financial-accounting-and-reporting-an-international-approach-european-edition-by-craig-deegan/

Ripslash Plc meets two of the above tests and therefore would be deemed to be a large public company and therefore would be subject to relatively extensive disclosure requirements.

2.25 The *Conceptual Framework* defines an asset as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. This definition identifies three key characteristics:

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

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

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

> *An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.*

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

2.26 The term *general purpose financial statements* refers to financial statements that comply with the conceptual framework, accounting standards and other generally accepted accounting principles and are released by *reporting entities* to satisfy the information demands of a varied cross-section of users. These reports can be contrasted with special purpose financial statements, which are provided to meet the information demands of a particular user or group of users. General purpose financial statements are defined in as the IASB *Conceptual Framework* as "those financial statements intended to meet the needs of users who are not in a position to require an entity to prepare reports tailored to their particular information needs".

If an entity is not deemed to be a 'reporting entity' then it will not be required to produce GPFSs; that is, it will not necessarily be required to comply with accounting standards. The determination of whether users are dependent upon GPFSs for the purposes of making and evaluating resource allocation decisions (that is, whether an entity is a reporting entity) requires professional judgment. Where dependence is not readily apparent, factors that may indicate whether the entity is a 'reporting entity' include the separation of management from those with an economic interest in the entity, the economic or political importance/influence of the entity to/on other parties and the financial characteristics of the entity.

(a) ABC Pty Ltd is a small proprietary company with two shareholders. In this case, management is not separated from economic interest as Mr and Mrs ABC are involved in the day-to-day operations. The only 'user' appears to be The Bank,

Copyright © 2013 McGraw-Hill Australia Pty Ltd

which receives management accounts and budgeted cash flow information. Providing The Bank does not advise that it is dependent upon GPFSs, and ABC Pty Ltd has no economic or political influence, ABC Pty Ltd does not appear to be a reporting entity.

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

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

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

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

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

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

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

Copyright © 2013 McGraw-Hill Australia Pty Ltd