**Role of the conceptual framework in Australia**

**Why has a conceptual framework been developed and what is its main purpose?**

The conceptual framework is **underlying theories** that provide a basis for developing accounting standards. Its purpose is enable regulators to

* develop standards that are consistent and logically formulated.
* provide accountants with guidance where no standards exist.
* help users to better understand the standards developed.
* assist auditors in deciding if financial reports conform with Australian accounting standards

In Australia, the conceptual framework consists of:

1. Australian Accounting Standards Board (AASB) Statement of Accounting Concepts (SAC) 1: 'Definition of the Reporting Entity'
2. Australian Accounting Standards Board (AASB) Statement of Accounting Concepts (SAC) 2: 'Objective of General Purpose Financial Reporting'
3. International Accounting Standards Board (IASB) Framework for the Preparation and Presentation of Financial Statements (the Framework). This has been adopted by AASB. It identifies:

* The qualitative characteristics of financial information.
* The elements of the reporting process e.g. assets, liabilities, equity, income and expenses and their recognition criteria.

**What is a reporting entity?**

An entity is a reporting entity if users of financial reports depend on the entity’s reports for information for decisions about the allocation of scarce resources. SAC 1 also requires company reports to comply with the Statements of Accounting Concepts and Accounting Standards

Examples:

1. Entities with a high degree of separation between owners and managers because the external users have less ability to obtain information about the financial position and performance of the entity. E.g. public companies and government departments.
2. Entities with a lot of economic and political influence in the community. Such companies contribute to employment and taxation e.g large oil companies, unions, employer associations, large national companies and government regulatory bodies.
3. Financial characteristics reflecting size may indicate a reporting entity. (number of employees, the value of assets, the level of income and the value of liabilities.) E.g. Large public companies with complex financial systems.

*Examples of reporting entities:*

Listed public companies e.g. National Australia Bank Ltd

Statutory authorities e.g. Water Corporation of Western Australia

Royal Flying Doctor Service of Australia

Australian Red Cross Inc

The definition is not limited to businesses or companies. Regardless of the nature of the organisation, if there are people who make decisions based on the reports, the definition applies. For example, shareholders require information about income and profit for investment decisions, and citizens and community groups require information about the spending of government agencies to budget and plan their future activities.

**What are General Purpose Financial Reports?**

**GPFR**s (or **GPFS** in international standards) are financial reports intended to meet the information needs of users who cannot command the preparation of reports for specific information needs. *Examples*

|  |  |
| --- | --- |
| ***GPFS*** | ***Information provided*** |
| Statement of comprehensive income | *Profit performance* |
| Statement of financial position | *Financial Position* |
| Statement of changes in equity | *Change in equity over a period* |
| Statement of cash flows | *Cash inflows and outflows over a period* |

**The objectives of GPFRs**

According to SAC2 the main objectives of GPFRs are:

* To provide information to users for making and evaluating decisions on the allocation of scarce resources.
* For management to be accountable for the resources entrusted to them.

SAC2 divides users into 3 categories

* Resource providers e.g. employees, lenders, creditors, suppliers and investors.
* Recipients or consumers of consumer goods and services. e.g. customers, taxpayers and ratepayers.
* Parties performing review function e.g. governments, regulatory agencies, labour unions, media and special interest groups

**Qualitative characteristics of financial information**

**Relevance**

Timeliness

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is.

However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

**Reliability vs Relevance**

Problem:

What is reliable is not always relevant.

What is relevant is not always reliable.

Where a choice has to be made, maximisation of **relevance** is the guiding principle. No matter how reliable information is, it is useless unless it is relevant.

*Example*

Alpha Limited is a public company with thousands of shareholders.

Alpha Limited purchased land in 1998 for $100,000. In 2010 the land was valued at $900,000.

In the balance sheet of Alpha Limited, on 30 June 2010, the land was shown at its current market value of $900,000.

Showing the land in the balance sheet at its current market value provides the shareholders of the company with **relevant** information about the value of an important asset of the company. The 1998 value can be supported by documents and hence **reliable**, but is far too outdated to be relevant for decision making.

**Comparability**

This characteristic will help the user compare

* changes in a business over time.
* performance of the business in relation to similar businesses.

This is necessary to compare:

* performance
* financial position
* cash flow

Comparability is achieved by treating items that are basically the same in the same manner for accounting purposes. It is also adopting the same methods over time e.g depreciation. This is the concept of *consistency.*

If a change in method is deemed necessary this fact should be disclosed in the notes to the accounts.

Consider:

*Does consistency mean using the same method of depreciation for all assets?*

*Should the same method be applied consistently if it is no longer relevant or reliable?*

**Understandability**

Accounting information should be:

* Expressed as clearly as possible.
* Understood by those for whom the information is prepared.

Consider:

*Does this mean that complex information should not be reported?*

Complex information that is omitted may be relevant.

Over simplifying it may affect reliability.

*Do you think that accounting reports should be understandable to those who have not studied accounting?*

Accounting reports are prepared on the assumption that the user has some knowledge of accounting and business and is prepared to spend some time studying the reports. Such a user is called a sophisticated user. A user lacking knowledge should consult a professional analyst to help him.

**Questions**

1. **Define the qualitative characteristic ‘understandability’ and give one example that applies this characteristic to the business.**

*Suggested answer*

***Understandability:*** *Information should be readily understandable by users, assuming they have a reasonable knowledge of business and economic structures. Complex information should not be excluded from the financial reports.*

*For example, a company can include information about depreciation in the reports without defining it or explaining the calculations used to determine the amount. It is reasonable to assume that the user of the report knows what depreciation is. If information is too complex it is expected that they will seek professional help.*

1. **Define ‘relevance’ and ‘reliability’ and explain how budgets can be an unreliable but relevant method of preparing financial information.**

*Suggested answer*

***Relevance:*** *Information is relevant when it influences the economic decisions of users by helping them predict or evaluate events or to confirm or correct their evaluation of the situation. The relevance of information is also affected by its nature and materiality.*

***Reliability:*** *Information is reliable when it is free from material error and bias and can be depended upon by users to represent items faithfully.*

*To be reliable,*

* *Information must faithfully represent the transactions or events it claims to represent.*
* *Information must also be presented in accordance with its substance, reporting economic reality and not merely legal form. (substance over form)*
* *the information must be neutral and free from bias.*
* *prudence must be exercised( a degree of caution when making judgments and estimates.)*
* *the information must also be complete and without material omissions.*

*A budget is unreliable because it is a future prediction of outcomes that are unknown, however it is relevant because it is used to plan the future direction of the company, providing guidance.*

1. **Use an example to explain how a user of accounting information might rely on the qualitative concept of comparability when reading accounting reports**

*Suggested answer*

***Comparability:***

*Users must be able to compare*

* *The financial reports of an entity* ***through time*** *in order to be able to identify trends.*
* *The financial reports of* ***different entities*** *in order to be able to evaluate their relative financial position, financial performance, and cash flow.*

*For example: if the company decides to change the method of valuing inventory the changes and its impact on the interpretation of the reports must be included in the notes to the accounts.*