Solution Manual

to accompany

Contemporary Issues in Accounting

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CHAPTER 2
THE CONCEPTUAL FRAMEWORK OF FINANCIAL REPORTING

Contemporary Issue 2.1 *The usefulness of financial reporting*

1. Should information in the financial reports be limited to financial or numerical information? (J)

First it should be noted that the information in the financial statements is supplemented by notes and in these there is non-finical and numerical information, although this could be argued to be restricted primary to explaining the numbers or financial information (so for example, explaining assumptions used , methods of estimations etc.

There are 2 views here:

- One view is that the role of accounting is limited in scope to financial issues and, hence, limited to largely financial information. Recall that the objective of financial reporting is not to provide all information users need but to meet information needs common to the specified users. It could be argued that providing information outside of this realm is not within the scope of financial reporting, by definition, and would also not be within the expertise of preparers. It is necessary to restrict information in these reports to make these comparable, understandable and also auditable. It should be noted, however, that in the annual reports (of which the financial statements and notes are a part) reviews by directors often provide some of this information (often required by corporations law), and many particularly larger companies voluntarily provide non-financial information about environmental and social performance.
- As noted in this extract relevant information is not limited to numbers. It could be argued that given that accounting is about 'accountability' the scope and role of accounting should be broadened to reflect the wider accountabilities of corporations in particular, or even that limiting reporting to financial information is not providing the information

required by decisions makers (users). The examples, provided in the extract: if a technology company hires one of the best minds in the field, would that information be an important factor in making an informed decision about the company's future economic prospects? Or if a bioengineering company lost its most productive R&D scientist, might that information influence stakeholders' decisions?- are pertinent ones. Given new technologies and developments (as outlined in the extract) is 'traditional' accounting failing its users.

2. What are the difficulties or problems in requiring companies to provide non-financial information about, for example, human capital, intangibles, or innovations? (J, K AS)

Students may identify a range of problems or difficulties including:

- If there are no 'standards;' concerning such items and their disclosure this could lead to inconsistencies even as to what information should be provided about, as well as level of detail of information. This of course would reduce comparability.
- How difficult would it be to provide assurance that this information is representationally faithful (i.e. how would you audit this information, particularly in relation to completeness).
- The incorporeal nature of items such as (for items such as human capital, innovations) necessarily means that in many instances identifying these and deciding on what impact or significance they have or may have is inherently subjective. This could impact on the usefulness of any information provided.

It should be noted that IAS 38/AASB 138, para 128 *encourages* entities to provide a description of significant intangible assets that have not been recognised as assets due to failing the recognition criteria.

Cleary including as financial information would be problematic:

- Whether these items would meet definition of assets; if not should we introduce new elements into the financial statements

- How would we measure such items? These would be difficult to value (either in attributing costs or future economic benefits)
- Inclusion of such items may involve subjectively. Could this result in difficulty auditing such information or provide directors or others with opportunities to bias results..

Note: a later chapter in this text discusses issue involved with accounting for intangibles.

Contemporary Issue 2.2 *New lease accounting to have big impact*

1. Consider the definitions of an asset and liability in the *Conceptual Framework*. Would a 5-year lease for land meet these definitions? (J, K)

Student should apply the definitions of an asset and a liability from the conceptual framework:

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

- Future economic benefits would be the right to use the assets (and the revenue/benefits that you obtain from using the land)
- Control would be established as given the contract the lessee can obtain the benefits from using the asset (remember that assets do not need to be owned).
- Past event – would be lease contract that gave rise to lessee having right of use of asset and controlling and accessing benefits.

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

- The future outflow of economic benefits/resources would be the meeting of lease payments)
- Present obligation – under leasing contract would assume have legal obligation to make payments.

- Past event – would be lease contract that gave rise to obligation.

Note: The current accounting standard on leases, AASB 117 *Leases*, overrides the general recognition criteria for liabilities and requires liabilities in relation to finance leases to be recognised. A finance lease is a lease in which substantially all of the risks and rewards incidental to ownership have been transferred from the lessor (legal owner of the property) to the lessee (one who is using the property) (AASB 117 para 4). Given that land has an indefinite life a 5 year lease of land would be classified as an operating lease and would not give rise to an asset or liability. Under the proposed leasing standard this would change and an asset and a liability would be recognised.

2. The extract discusses the fact that these changes reflect the way in which accounting is moving — that is, towards putting all assets and liabilities on the balance sheet. What reasons could there be for this move? Given the identified impact on key company ratios, do you believe this approach is justified? (J)

Reasons towards the move towards putting all assets and liabilities on the balance sheet would be:

- Based on principles & objectives of financial reporting: To be consistent with the conceptual framework all items that meet the definition and recognition criteria of assets and liabilities should be included on the balance sheet. Also to be complete and so representationally faithful would argue that need to include all elements. Surely information about the assets and liabilities of an entity would be relevant to users.

- Improves comparability as does not distinguish on form or arbitrary rules but reflects economic substance. For example, under current lease accounting 2 entities could have identical items of land – one entity owns and one leases (as operating lease). The different accounting treatment would result in one entity including an asset but the leasing one not. This would distort rations such as return on assets etc and make comparison difficult.

- Reduces opportunities to structure transactions on order to reflect a particular financial position (this could include maintaining certain ratios). If all assets and liabilities meeting the recognition criteria are required to be included on the balance sheet then this limits the ability of entities to choose or plan transactions to avoid including these on their balance sheet or in particular to ‘hide’ obligations/ /commitments. Under the current leasing arrangements company may decide to lease land rather than purchase (even those costs and commitments may be relatively equal) as leasing will avoid the recognition of the lease liability and asset. It could be argued that the use of special purpose entities by Enron which were not required to be included on the balance sheet and were used to hide debt is an example of structuring transactions to reflect a particular financial position.

Cleary including all assets and liabilities on the balance sheet would impact on key financial ratios. Whilst it could be argued that this could disadvantage some companies (for example, if they are now required to include such assets and liabilities this could mean that they may breach debt covenant ratios and incur costs unless they are able to renegotiate debt terms/covenants). However an alternative argument is that if all assets and liabilities are included then this provides a more complete and representationally faithful view of the financial position and hence the ratios are more ‘accurate’ and useful.

Review questions

1. What is a conceptual framework?

A conceptual framework is defined in the text as a set of broad principles that provide the basis for guiding actions or decisions. An accounting conceptual framework can be described as: a coherent system of concepts that underlie financial reporting. As the *Conceptual Framework* (page 26) states 'This Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users.'

2. What is the difference between a conceptual framework and accounting standards?

Essential points relate to:

- The conceptual framework provides high level concepts such as definitions of elements of financial statements, qualitative characteristics, definition of the objective of general purpose financial reporting. Standards apply the concepts in specific situations — for example, accounting for financial instruments, leases and inventory.
- The standards setters base new accounting standards, and amendments to old, on the conceptual framework.
- Standards take precedence in the event of conflict as the *Conceptual Framework* (page 6 notes). In Australia, the *Conceptual Framework* does not have legal force for reporting entities subject to the Corporations Law; accounting standards do. However, concepts from the conceptual framework are now included in all new and reissued accounting standards. Therefore, application of such embedded concepts is mandatory because these are included in accounting standards.

The differences are illustrated with the following examples.

IAS 1/AASB 101 para 9 outlines information about the purpose and elements included in a financial report:

> Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity's:
> (a) assets;
> (b) liabilities;
> (c) equity;
> (d) income and expenses, including gains and losses;
> (e) contributions by and distributions to owners in their capacity as owners; and
> (f) cash flows.
>
> This information, along with other information in the notes, assists users of financial statements in predicting the entity's future cash flows and, in particular, their timing and certainty.

The Conceptual *Framework* (para. 4.4) provides definitions of basic elements to be included in the statement of financial position such as:

(a) *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.*

Accounting standards provide *specific* requirements for a *particular* area of financial reporting. These are required to be complied with via corporations law.

For example:

IAS 1/AASB 101 *Presentation of Financial Statements* specifies that:

> particular assets or liabilities must be included on the face of the report itself (such as intangibles).

AASB 102 *Inventories* (para. 5.2) specifies that:

> inventories *shall be measured at the lower of cost and net realisable value*

3. Outline the technical benefits of a conceptual framework. What problems could occur if accounting standards were set without a conceptual framework?

The technical benefits relate to improving how financial reporting works — either though improving quality, or accounting practice, via improving understanding. The *Conceptual Framework* outlines these under its purpose section (page 6).

> (a) to assist the Board in the development of future IFRSs and in its review of existing IFRSs;
> (b) to assist the Board in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs;
> (c) to assist national standard-setting bodies in developing national standards;
> (d) to assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;
> (e) to assist auditors in forming an opinion on whether financial statements comply with IFRSs;
> (f) to assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs; and
> (g) to provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

In the AASB *Framework* these are listed para. 1 (a) to (g).

The problems that could occur if standards set without a conceptual framework is:

- Inconsistencies between standards if different concepts/principles used to develop different accounting standards
- Time frame for developing standards could be longer as would need to debate underlying principles/concepts each time new standard developed/changed.

4. How can the conceptual framework help users and preparers understand accounting requirements and financial statements?

The conceptual framework can assist users and preparers as:

- Accounting standards based on the conceptual framework should be more consistent
- Rationale for standards should be apparent as based on underlying concepts which are explicitly stated in the conceptual framework.

5. What is the objective of financial reports according to the *Conceptual Framework*?

Historically, external financial reports were prepared (and required) to ensure minimum information was given to investors to make informed judgements about the performance of management and the security of investments. The need to protect the rights of external users of information, who are not involved in the operations of the company, is the primary justification for the need for external financial reporting. Such reports are used as a source of information for those parties who are planning to transfer resources to an organisation.

The *Conceptual Framework* outlines the purposes of financial reports:

> The objective of general purpose financial reporting* is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit. (OB2)

Hence should note:

- Objective is to provide information for decision making
- Identifies specific decision makers and types of decisions and limits to these.

Students should note that the revised *Conceptual Framework*:

- Restricts users and decisions whereas previously these were much broader
- Does not explicitly include in its objectives the discharge of accountability/stewardship.

6. How is the decision usefulness approach reflected in the *Conceptual Framework*?

An essential point to note is that the conceptual framework is based on the decision usefulness approach to accounting theory. The outputs of the accounting system are inputs to user decision processes.

This emphasis is reflected both in the objective of general purpose financial reporting (this is to provide information … that is useful to ... in making decisions) and in the qualitative characteristics.

Paragraph QC1 of the *Conceptual Framework* defines qualitative characteristics as:

> The qualitative characteristics of useful financial information discussed in this chapter identify the types of information that are likely to be most useful to the existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report (financial information).

Although all aim of all of the qualitative characteristics is to ensure that information is useful the one that best reflects the decision–usefulness approach in the conceptual framework is relevance.

The qualitative characteristic, relevance, is one of the qualities that should be reflected in the information provided by general purpose financial reports. Relevance is outlined in the *Conceptual Framework* (para. QC6) as:

> 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.

Paragraph QC7 of the Conceptual Framework states:

> Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both.

You should see that this has two roles: predictive and confirmatory (or feedback) and that these are interrelated (refer QC8 to 10).

Prediction: Part of the definition of relevance focuses on accounting information as an input to user prediction models. Information may help to predict future earnings or cash flows from future dividends, for example.

Confirmation (Feedback): Part of the definition notes that information is also relevant if it plays a feedback or confirmatory role in the decision process.

Most descriptions of decision processes view decision makers as seeking information:

- to help predict the future values of variables of interest for a decision, for example future revenues and future costs. Information plays a predictive role. Information about past events is fed into a decision model to help predict future values of the variables of interest (part (a) of the definition); and
- for confirmation or feedback, to help monitor the outcomes of past decisions part (b) of the definition).

7. The *Conceptual Framework* states that 'general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need' (para. OB6). What information is not provided and why?

As stated in the *Conceptual Framework*:

> IOB6 However, general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.
> OB7 General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity.
> OB8 Individual primary users have different, and possibly conflicting, information needs and desires. The Board, in developing financial reporting standards, will seek to provide the

> information set that will meet the needs of the maximum number of primary users. However, focusing on common information needs does not prevent the reporting entity from including additional information that is most useful to a particular subset of primary users.

There are a number of key limitations and/or omissions to the information provided in the financial reports:

- Information on general contextual issues (such as economic conditions) is not included.
- Information is limited to common information needs; so is not tailored to individuals or even individual user groups, which may require information specific to their decisions.
- The financial reports do not provide future orientated information. The focus of information provided in the financial statements is on past performance/position, and while these can be used to make predictions, these in themselves are not future orientated.
- Non-financial information is also limited. Although limited non-financial information is provided, the main information in financial reports is financial. Relevant information is not limited to numbers. For example, if a technology company hires one of the best minds in the field, would that information be an important factor in making an informed decision about the company's future economic prospects? Or if a bioengineering company lost its most productive R&D scientist, might that information influence stakeholders' decisions? It should be noted, however, that in the annul reports (of which the financial statements and notes are a part) reviews by directors often provide some of this information (often required by corporations law), and many particularly larger companies voluntarily provide non-financial information about environmental and social performance.

Why is this information not provided?

There are alternative views, and also advantages and disadvantages, in providing such information. One view is that the role of accounting is limited in scope to financial issues and, hence, limited to largely financial information. Others would argue that given that accounting is about 'accountability' the scope and role of accounting should be broadened to reflect the wider accountabilities of corporations in particular, or even that limiting reporting to financial information is not providing the information required by decisions makers (users).

8. What is the underlying assumption to be applied in preparing financial reports according to the *Conceptual Framework*? How does this assumption affect the financial report items?

The underlying assumption identified in the *Conceptual Framework* in the preparation of the financial statements is the going *concern basis*.

The going concern basis is described in paragraph 4.1 of the *Conceptual Framework*.

> The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Applying this basis means that a longer term view of economic benefits and outflows can be considered. If this was not used (i.e. it was assumed that a company as at balance date would not be continuing in its operations) this would require assets/liabilities etc. to be measured on a liquidation basis. For many items this would significantly impact on their measurement and even whether they would be recognised at all (for example, prepaid insurance if the company was not continued would be unlikely to provide any future benefits). Of course if this does not apply (i.e. the entity is not a going concern) then as stated, disclosure of this is required and a different basis would normally be appropriate.

9. Identify the qualitative characteristics of financial information in the *Conceptual Framework*. How are these related to the objectives of general purpose financial reports?

The *Conceptual Framework* states that:

> QC 1. The qualitative characteristics of useful financial information discussed in this chapter identify the types of information that are likely to be most useful to the existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report (financial information).

> QC4 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.

So the role of qualitative characteristics is to ensure that information provided to users has these qualities as they will help ensure that the information is useful to users. This is directly related to the objective of general purpose financial reports, which in the *Conceptual Framework*, is to provide information that is useful to range of users in making decisions.

The *Conceptual Framework* identifies 2 fundamental qualitative characteristics: relevance and faithful representation. To be useful information must have both of these. As the *Conceptual Framework* states:

> QC17 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.

It also identifies a number of enhancing qualitative characteristics (comparability, verifiability, timeliness and understandability) which increase the usefulness of information, Each of these qualitative characteristics is outlined in the *Conceptual Framework* and these outlines link each qualitative characteristics with the usefulness and use of information by users.

For example the qualitative characteristic of timeliness states:

> QC29 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.

Students should recognise that there may be a need to balance these qualities and trade these off. For example:

- The cost of an item purchased 20 years ago is verifiable however, it may not be relevant. A more relevant measure (such as what it could be sold for now, or the cash flows it is expected to generate in the future) may be less verifiable.

This need to trade off is explicitly recognised in the *Conceptual Framework*

> QC34 Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximise another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying a new financial reporting standard may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for non-comparability.

It is important to understand these qualitative characteristics because these factors should be a key part of consideration in the areas where accountants are required to exercise judgement (e.g. in relation to accounting policies, etc.).

10. Not all relevant and faithfully representative information will be included in financial reports due to the materiality aspect and cost constraint identified in the *Conceptual Framework.* Outline the materiality aspect and the cost constraint on the provision of information. Can you think of any problems in applying these?

Materiality can be considered as aspect of relevance and material information is outlined in the *Conceptual Framework* as:

> QC11 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 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.

The cost constraint is outlined as:

> QC35 Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider...

Problems in applying would include:

- Both of these require judgement. This leaves open the possibility of different interpretations, which could cause inconsistencies, and also the opportunity for motivations such as self interest to distort or bias this judgement. This inherent subjectivity involved in applying the cost constraint is recognised explicitly in the *Conceptual Framework* (see QC39).
- These decisions are made by the preparers of the financial reports and yet these constrain the information provided to users. For example, most of the costs of preparing reports are borne by preparers (and companies) yet the benefits are for users. However, the preparers weigh the costs to them against their perceptions of the benefits to users; is this a conflict of interest?

11. What is the difference between recognition and disclosure in accounting? According to the *Conceptual Framework*, when should an item be recognised in the financial reports?

Recognition is the process of recording information about an element *in the body* (on face) of the financial reports (*Conceptual Framework*, paragraph 4.37). Disclosure normally means that information is included (disclosed) *either* in the body (on the face of the reports) or in the notes to the accounts.

> Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 4.38. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals. Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material

Students may also refer to para. 48 of AASB 101:

> 48. This Standard sometimes uses the term ‘disclosure’ in a broad sense, encompassing items presented in the financial statements. Disclosures are also required by other Australian

> Accounting Standards. Unless specified to the contrary elsewhere in this Standard or in another Australian Accounting Standard, such disclosures may be made in the financial statements.

The following illustrate the difference between recognition and disclosure and although we normally consider disclosure to mean either on the face of the reportss or in the notes, in some cases disclosure will be restricted to the notes:

- A company may have a relatively small expense (e.g. for postage). This would meet the definition and recognition criteria of an expense and thus be recognised (included in expense on the face of the relevant statement). However, this item (postage expense) would not need to be separately disclosed.
- A company may have a relatively large expense (e.g. for cost of sales). This would meet the definition and recognition criteria of an expense and thus be recognised (included in expense on the face of the relevant statement). However, as this item is material (users need to know about this) it is required to be disclosed. Hence, would need to disclose the amount for this expense separately, either in notes or on the face of the relevant report.
- A company may have an item that meets the definition of a liability but not the recognition criteria (for example, has been found liable in a court case but the amount to be paid has not yet been determined and cannot be estimated). In such cases, the relevant standard, AASB 137, requires disclosure of the item. As this does not meet both the definition and recognition criteria, it cannot be included or disclosed on the face of the financial statements. However, information about this item would be disclosed separately in the notes

Recognition is a two-stage process

Firstly, the item must satisfy the definition of an element of the financial reports. Secondly, information about an element will be *recognised* in the financial reports if it satisfies certain recognition criteria (these relate to probability and reliable measurement).

To know how this works we must understand the recognition criteria. The *Conceptual Framework* states that:

> 4.38 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.*****

Probability test

In the *Conceptual Framework* the term 'probable' refers to 'the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity ' (para. 4.40). You need to consider the available evidence. In terms of probability levels, this is usually interpreted as saying that the chance of economic benefits arising, or of a disposition of economic benefits occurring, is more likely rather than less likely. Pierson (1988) interprets this to mean that the probability level must exceed.

Reliable measurement

For an item to be recognised it is necessary that it possess a cost or other value that can be measured reliably. The qualitative characteristic 'faithful representation' has now replaced 'reliability' which was previously a separate qualitative characteristic. The *Framework* outlined reliability as:

> 31 To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Hence a measure that meets the qualitative characteristic of faithful representation could be presumed to meet this recognition criteria. The enhancing qualitative characteristic of verifiability would also improve the reliability of measures.

The appropriate measurement basis for assets and liabilities has not been addressed in the *Conceptual Framework*.

Students should note that information about elements that are not recognised may be disclosed by way of notes to the reports (para. 4.4.3), or may be recognised later if the recognition criteria are subsequently met (para.4.4.2).

> 4.43 An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and changes in financial position of an entity by the users of financial statements.

12. Why is accounting said to be 'political' in nature? How can a conceptual framework help in the setting of accounting standards in a political environment?

The political nature of accounting is due to the fact that accounting information is used in, and influences, decisions. Thus, the accounting 'rules' determine what information is provided and therefore what information is used in decisions. Recall that the objective of financial reporting is to provide information useful to users in making economic decisions. If economic decisions change and are influenced by accounting then this means that accounting information has economic consequences (i.e. can result in transfers of wealth). Thus, people will try to influence the accounting rules (the accounting standard) to try to ensure that their own interests are met.

The claim is that the conceptual framework provides some defence against 'political interference' as the framework can be used to justify the choices/decisions made by accounting standard setters in determining accounting rules. Also, individuals arguing against standards will find this more difficult if their arguments are inconsistent with the agreed *Conceptual Framework*.

13. It is claimed by some that the reason for conceptual frameworks in accounting is to protect the accounting profession rather than improve accounting practice. Explain the basis for this claim.

Students should note the following major points.

1. Accountants have a special status in society. In Australia, this is witnessed by the Royal Charter endowed on the Institute of Chartered Accountants, the media profile associated with the CPA program of the Australian Society of CPAs, and the professional monopoly (or almost) by the two major accounting bodies.
2. The hallmark of a profession is possession of a unique body of knowledge. Loss of professional status means that the power, prestige, self regulation and economic position of accountants are eroded.
3. The ability of the accounting profession to retain legitimacy as a profession will be judged by society, in terms of the apparent coherence and theoretical defensibility of the profession's body of knowledge; hence the need for a conceptual framework (Hines, 1989).
4. The conceptual framework plays a vital political role in maintaining self-regulation and in lobbying against increased regulation by government bodies.
5. According to a social constructionist view, as put by Hines, the conceptual framework project is not about setting rules for accounting practice; rather, it is about legitimising the process by which accounting practice is done. That is, the accounting profession:
    - does not really value a conceptual framework for its potential technical benefits
    - does value the appearance of having a conceptual framework to claim a unique body of knowledge to maintain its professional status, associated privileges and power.

14. Some people argue that the conceptual framework is acceptable in theory but in practice it does not work. Explain possible problems with and criticisms of the current *Conceptual Framework*. Do you think these problems exist and criticisms are valid?

The problems or criticisms are:

- Too ambiguous and open to interpretation. By definition a conceptual framework provides broad concepts and, thus, any conceptual framework often will be open to interpretation. If too rigid, then the *Conceptual Framework* would not be broad enough or flexible enough to deal with the wide range of transactions, events and issues related to financial reporting. However, this broadness also means it can lead to inconsistencies. Presumably this is why there are more detailed standards, and we need to think here about the purpose of the *Conceptual Framework*. Its key purpose is to guide accounting standard setters and to provide guidance where there are no standards.

- It is incomplete. This criticism, particularly in relation to measurement, is valid.
- It is too descriptive. This criticism argues that because much of the *Conceptual Framework* reflects historical accounting practice, rather than driving and informing accounting practice, it merely codifies what is currently practiced. Whether you accept this criticism as valid or not will depend on your view of what accounting should do, and especially in relation to the scope and purpose. An alternative view is that accounting practice has developed over time and it is reasonable to assume that much of current practice is 'correct'.
- The meaning of faithful representation is problematic. This is expanded on in the answer to question 2.15.

15. Explain why some people believe that the concept of faithful representation in the *Conceptual Framework* is incorrect.

First students should consider the definition of this term in the *Conceptual Framework*.

Faithful Representation

> QC12 Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete*, *neutral* and *free from error*. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximise those qualities to the extent possible.

This answer explains this rationale for those who believe that this is incorrect by considering the meaning of this term as it relates to different word views about the nature of accounting.

Alternative views of nature of accounting

Realist view — assumes that an objective reality exists independently of the observer; the world of theory and reality are separate. This assumes that there is an objective reality that exists independently of our accounts of it. The task is to 'discover' and record what it is that objectively exists. This assumes that the observer is independent of the events observed (and vice versa), and that our theories about the world do not affect the observers or observations made. Our observations are objective — we merely see what is 'out there' to be discovered. In accounting, this view assumes that the transactions and events that accountants describe and report exist independently of the descriptions themselves.

Materialist or Social constructionist — this alternative view argues two points:

- Our accounts of reality act upon reality and come to form part of that reality; 'that our knowledge of the world is just as much an invention as it is a discovery'. Our accounts construct the reality that they purport to describe. Therefore, accountants are not impartial, value-free score-keepers — they are involved in constructing the financial reality of a reporting entity; and
- Once the account of reality is accepted, we act on that account. Our theories about the world come to control us as they exert an irresistible influence on our actions. (Students should refer to the discussion of the scorers in the football game that is set out in the topic overview.)

View reflected in the representational faithfulness qualitative characteristic

Representational faithfulness means the correspondence between a measure or description of events or objects and the events or objects themselves.

The definition assumes that the task of accounting is to faithfully represent, i.e. mirror economic transactions and events. The concept of representational faithfulness implies the assumption of 'realism'. This implies that there is a reality that accountants can observe objectively/neutrally and faithfully describe — the realist view.

Whether or not the view of reality reflected in the representational faithfulness (realist view is the correct view.

Accounting cannot mirror transactions and events if there is not an objective social reality that is unaffected by our accounts of it. Those who believe in the alternative world view (materialist or social constructionist) would hence argue that concept of representational faithfulness is based on a flawed view of reality. The key point here is that financial reality, or financial 'facts' (such as profit, liquidity, asset levels) do not exist independently of our measures of them. Accounting measures are not like natural phenomena (the sun, the moon etc.) that are there to be simply discovered. The problem is the numbers we report are not representations of objects. Accounting measures only arise via application of various rules and choices. Descriptions of abstractions such as net profit or financial position do not exist independently of our measures of them. In this way, accountants can be said to construct financial reality. See the example in the text in relation to different measures and different resulting profit figures.

Application questions

2.1 As a group, identify two or three general principles to help guide the making of more specific rules in relation to a particular area, context or task. For example:

- **It may be that a group of students is planning on sharing accommodation (such as an apartment).**
- **You may be required to undertake a group assignment.**

Once you have agreed on the two or three principles, use these to form more specific rules in relation to the context or task. Then consider the following questions:

(a) How easy was it to agree on the basic principles?

(b) Are all the rules consistent with these principles?

(c) Have any members interpreted the principles differently?

(d) How useful were the principles in helping establish more specific rules?

(e) Were there any problems with using principles as a basis for setting the rules? (CT, SM)

There are no set answers here. You would expect that students have difficulty setting the initial principles. By attempting to apply these principles, it is likely that the original principles will be amended, or different interpretations allowed.

This should demonstrate a number of issues:

- The difficulty (and time required) in arriving at agreement
- The fact that individuals will interpret statements of principles differently (perhaps in line with their own preferences, situation and experiences) even where other individuals have believed that the rules were clear.
- Once established, the principles do reduce time to agree on more specific rules and also are used to justify agreement/disagreement of differing interpretations.

2.2 Look at the accounting standards. Then: (K, AS)

(a) Find examples of how parts of the conceptual framework (e.g. the definitions, recognition criteria, qualitative characteristics) have been included in them.

Students should be able to find numerous examples such as:

- IAS 8/AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* includes criteria to change accounting policy, and the qualitative characteristics of relevance and reliability (which includes representational faithfulness).
- IAS 38/AASB 138 *Intangible Assets* includes recognition criteria before an intangible asset can be recognised, identical to that in the *Conceptual Framework*
- IAS 37/ AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* includes the definition of a liability as per the *Conceptual Framework*.

(b) Identify any inconsistencies between the requirements in accounting standards and the *Conceptual Framework.* Why do you think these occur?

Two inconsistencies are:

- IAS 17/AASB 117 *Leases* does not allow non-cancellable operating leases to be recognised as assets yet these would appear to meet the definition of an asset in the framework. Note: an exposure draft is expected to change this to be consistent (or at least more consistent) with the conceptual framework
- IAS 38/AASB 138 *Intangible Assets* does not allow the later recognition of items that have been expensed but now meet the definition and recognition criteria of an asset. Yet the *Conceptual Framework*, para 4.42, states ‘ An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 4.38 may qualify for recognition at a later date as a result of subsequent circumstances or events.’
- IAS 38/AASB 138 *Intangible Assets* does not allow recognition of some internally generated assets (such as brands etc) even if these meet the definition and recognition criteria for an asset in the *Conceptual Framework*

Students may identify other inconsistencies. Possible reasons for inconsistencies could be:

- Accounting standards originally evolved without *Framework*
- Opposition to change by interest groups
- Concern that any alternatives permitted would reduce consistency or provide opportunities for manipulation.

2.3 Find the comments letters received on a current exposure draft or proposal. (These can be found from the websites of most standard-setting organisations, such as IASB, AASB or FASB). Read a sample of comments from a range of respondents (e.g. from accounting bodies, industry, company or corporate bodies) and answer the following questions: (K, AS, SM)

No specific answers are provided here as this will depend on current exposure drafts and the nature of these as to comments and responses received. The following gives some issues to consider.

(a) Is there agreement among the various groups?

If there is disagreement is this related to groupings (e.g. smaller reporting entities; not-for–profit; accounting firms versus academics).

(b) If there are any concerns or objections, are they based in conceptual issues, practical issues or potential economic consequences? Does this vary among groups?

Again consider the nature and impact of proposed changes on the various groups — if economic consequences or impacts of changes vary across groups this is likely to influence reactions. You will often find a range of justifications — some will argue practical problems, others economic consequences, others conceptual issues (or a combination).

(c) Have any of the comments letters referred to the *Conceptual Framework* as a basis to support their views?

Again this will depend on current exposure drafts and the nature of these as to comments and responses received. An interesting (if old) exposure daft to consider is ED 140 *Proposed Amendments to AASB 137 Provisions, Contingent Liabilities and Contingent Assets*. Various comments and letters indicate proposal inconsistencies with the current conceptual framework (see comments from Deloittes), although others support in principle but argue pragmatic problems with measurement (see comments from Group of 100).

(d) Do the comments letters suggest that there is support for the current *Conceptual Framework*?

Again this will depend on current exposure drafts and the nature of these as to comments and responses received. However, think about the following question — are they supporting framework because the resulting outcome is in their interest or supports their viewpoint?

2.4 The following information is provided for two items of property for a company. Property A was purchased five years ago for $400 000. It was intended to be used to build another factory but the company has now reorganised its original factory and it is no longer required. The company now intends to sell it. The current property market has dropped but is expected to rise when interest rates fall. If sold now the property is expected to realise $360 000.

Real estate experts have predicted that if the company waits for the property market to recover, it could realise $450 000.

Property B is the current factory. It was purchased ten years ago for $200 000. If sold now, it would be expected to realise $380 000 (and $500 000 if the property market recovers). The company has various estimates about its contribution to the profit of the company. Using current interest rates and various assumptions about future sales and costs, the property is calculated to have a present value (in terms of future cash flows) of $900 000. It is insured for $600 000 because this is the cost required to rebuild it.

The company has always recorded property using the historic cost basis. Other companies in the same industry have traditionally used the same basis, although about 40 per cent now use the fair value basis. (J, K)

(a) For each of the properties identify which cost or value would best meet each of the following qualitative characteristics of:

- **faithful representation**
- **relevance**
- **verifiability**
- **comparability**
- **understandability**

Faithful representation

Recall that faithful representation requires to represent faithfully what it purports to represent and to be complete, neutral and free from error. This also requires a description of what the number represents. Hence:

- Cost, if clearly indicated as cost, for both is clearly a faithful representation (although remember we normally adjust cost via depreciation which involves estimates).
- Current and future fair values would also be a faithful representation providing that it is clear is an estimate and 'the nature and limitations of the estimating process are explained' (refer QC15).
- Likewise present values could also be considered a faithful representation providing that it is clear is an estimate and 'the nature and limitations of the estimating process are explained' in such a case it would also be required that assumptions etc made to achieve this estimate were outlined.

Relevance

Recall that relevance will vary depending on the user's perspective and the decision being made. For Property A the most relevant measure would be fair value as this is intended to be sold. Whether current fair value or expected fair value is more relevant will depend on users' perspective and also whether or not the company is intending to 'wait' until market recovers before selling.

For Property B from shareholders perspective (as interested in long term cash flows) then the present value would appear most relevant, although cost obviously also relevant (as this will determine profit made that can be distributed as dividends et). For other users, **perhaps**

assessing liquidity or safeguarding funds provided to the company current fair value may be most relevant.

Verifiability

- The original costs could be verified from documentation.
- The verifiability of current fair value would be more problematic and would depend on whether information was available about recent similar sales etc. Recall that to be verifiable one aspect is that independent observers could reach consensus. Future fair values would be even less verifiable, as this relies on making assumptions about the property market in the future, which would be more likely to vary and be contestable.
- The verifiability of present value for Property B would also be less as this requires estimates of future events and is also influenced by choices about interest rates used. The insurance amount would generally be verifiable given it is part of a contract (this would vary, very reliable if set amount in policy; could vary if policy relates more generally to replacement costs).

Comparability.

As the companies have in the past used cost this would assist in comparison across time. As other companies use either cost or fair value these measures would be useful for comparisons.

Understandability

The original costs, fair values and insurance value would be easily understood. The only value that could be more difficult to understand would be the present value for Property B as this requires an understanding of the item value of money and the impact of assumptions in relation to future cash flows, costs and interest rates. However the conceptual framework expects users to 'have a reasonable knowledge of business' (QC32).

(b) For each of the properties, choose which cost or value should be stated in the financial statements. Explain why you have chosen it and how you balanced the qualitative characteristics.

Students may arrive at different decisions. It could be argued:

- For Property A choose current fair value. Although less verifiable than cost, providing information is provided about this as an estimate it would be representationally faithful and it is more relevant given that the company intends to sell and future fair value is not sufficiently verifiable.
- For Property B choose cost. This is verifiable (especially as compared to present value) and still comparable with most other companies in the industry. Fair value is not relevant as intending to use asset.

(c) Do you think everyone would agree with your choices?

No, particularly in relation to Property B; it could be argued that cost has no relevance.

The following questions (2.5–2.7) require you to apply the definitions and recognition criteria in the *Conceptual Framework* to specific cases. After you have answered these questions, compare your answers with those of other students. Do your answers differ? How did using the *Conceptual Framework* help you to make your decision?

2.5 A company has a copper mine in South Africa. It purchased the mining rights ten years ago for $20 million and has been operating the mine for the past ten years. It is estimated that there are about 8 million tons of copper in the mine. Because of a fall in world copper prices, the company has closed the mine indefinitely. At current world copper prices, the mine is uneconomic because the costs involved in extracting the copper are greater than the selling price. If copper prices rise by more than 25 per cent, the company has stated that the mine would be reopened.

Applying the principles in the *Conceptual Framework*, explain whether this mine would: (J, K, AS)

- **meet the definition of an asset**

You would need to determine if the item has the 3 characteristics of an asset. Recall as asset is defined in the ***Conceptual*** *Framework* (para. 4.4) as:

> 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.

- Are there future economic benefits?
  – The company has no current economic benefits flowing as at present, given current prices, the costs to extract are greater than the selling price of the copper extracted (but asset require future economic benefits not present economic benefits). It could be argued, however, that there are potential future economic benefits and thus, it meets the definition of an asset (whether these will be realised relates to the probability of copper prices increasing by 25%).

   - Others could argue that future economic benefits are expected only IF copper prices rise by 25% and, hence, does not at present meet this characteristic.

- Does the entity have control?
   - Assuming that have taken position that have potential future economic benefits then company has control as is the only entity to have access to any potential benefits from the mine (given legal rights it only can extract copper and sell) and so can restrict access to any benefits that could be realised (no one else can mine)

- As a result of past event?
   - Assuming that have taken position that have potential future economic benefits then control of these benefits due to past event of purchasing mining rights.

- **Pass the recognition criteria.**

Recall the recognition criteria are in the ***Conceptual** Framework* (para. 4.38):

(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.

- Is it probable that future benefits will eventuate?
   - This is dependent on whether copper prices rise by 25% or more. Would need to make a determination of this given expectations of the copper market/cycles/trends etc.

- Is there a cost or value that can be measured reliably?
   - It states that the company has purchased mining rights so presumably the cost of this is known and could be determined — reliable measure available. The *Conceptual Framework* does not require a reliable measure of value — it states cost or other value.

Students should recognise that there is no 'correct' answer. Whether or not an asset is recognised in such a situation depends on interpretations of the *Conceptual Framework* and application to the particular case plus the actual circumstances of the entity.

2.6 The company is currently growing and it is expected that in five years an additional factory will need to be built to meet product demand at a cost of $500 000. The directors wish to recognise an expense of $100 000 and a liability (provision for future expansion) for each of the next five years.

Applying the principles in the *Conceptual Framework*, explain whether:

- **the definition of an expense is met.**
- **the recognition criteria for an expense are met. (J, K, AS)**

Recall that the definition of an expense is related to assets and liabilities:

> 4.4(b) 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.
>
> 4.25(b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

If we were to account for this as suggested by the directors, we would prepare the following journal entry:

Dr Expense
Cr Liability for Future Factory

It is probably easier to explain this in terms of the fact that there is no liability in this case. This would not constitute a liability. Recall that a liability has three characteristics:

1. Expected outflow of economic benefits
2. A present obligation
3. Due to past event

Although it is probable a future outflow of resources will be made (i.e. money will be spent on replacement) there is currently no obligation to an external party to make this outflow in the future, so not as yet any past transaction.

As the *Conceptual Framework* states:

> *4.1.6 A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset.*

IAS 37/AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* confirms this position and states that 'only those obligations arising from past events and existing independently of the entity's future actions (that is, the future conduct of its business' satisfy the definition of a liability 'because the entity can avoid the future expenditures by its future actions' (para. 19).

As we have no incurrence of liabilities or decreases in assets there is no expense.

2.7 The company has recently issued some preference shares. The terms of these shares are:

- **A fixed dividend of 3 per cent is payable each year. If no profit is available to pay dividends in one year, these will be back-paid in future years.**
- **The preference shares will be redeemed (bought back) by the company in three years at their issue price.**

Applying the principles in the *Conceptual Framework*, explain whether these preference shares should be considered as equity or a liability. (J, K AS)

First we need to consider the definitions of these items. In the *Conceptual Framework* these are:

> 4.4. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:
>
> (b) 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.

(c) Equity is the residual interest in the assets of the entity after deducting all its liabilities.

The first point to note is that we consider the substance of the transaction not the legal form. So the fact that these are called ‘shares’ does not determine whether or not they are considered equity or liabilities.

The definition of equity is a residual — we measure this by considering assets and liabilities — so we must first consider the liability definition.

Recall that a liability has three characteristics:

1. Expected outflow of economic benefits
2. A present obligation
3. Due to past event

Applying these to the first component of these shares — the cumulative fixed dividends.

- Expected outflow of economic benefits:
  Yes — if and when these dividends are paid will require an outflow of cash by the company

- A present obligation:
  Technically there is no legal right to dividends unless declared (which is normally at the discretion of directors). Hence, until a dividend was declared there would be no present obligation of the entity to make these future outflows and this characteristic would not be met.

- Due to past event:
  There is no event (until dividends declared which would then be past event) to obligate the company.

Therefore, this would suggest the share is equity.

Applying these to the second component of these shares — the redemption by the company in 3 years at the issue price.

- Expected outflow of economic benefits:

  Yes — when these shares are bought back this will require an outflow of cash by the company

- A present obligation:

  The terms of the issue indicate that the company is legally obligated to purchase the shares from the shareholders in 3 years time for the issue price, therefore, this characteristic would be met.

- Due to past event:

  There would be the issue of the shares under terms requiring company to redeem in 3 years time.

Therefore, this would suggest the share is a liability.

In practice the accounting standards require the separate classification of components into equity and liability respectively.

Case Study Questions

Case study 2.1 ***Code of Ethics***

1. Can you identify any potential problems or criticisms of the principles outlined in the *Conceptual Framework* in the case? (J, K)

The key problem with this set of principles is their broadness and the vagueness which is associated with conceptual frameworks in general. The advantages of this conceptual framework are identified at the end of the extract. The key disadvantage is in the vagueness of terms and in specific application of these principles to practice. For example, what level of professional knowledge is to be maintained to ensure competent service?

2. Do you think using these principles would be interpreted and applied consistency between the accountants in determining whether an action is ethical? (J)

Students should recognise that there would be differences in interpretation and application of these concepts. For example, what would people interpret as honest? Would the idea of this vary between individuals and particular circumstances? (In terms not of lies, but missions or incomplete statements). Is honesty in business simply ensuring the letter of law is followed or is it more than this?

3. How effective do you think such a framework is in (a) ensuring accountants act ethically and (b) enforcing or penalising unethical behaviour? (J, K)

Students should recognise that whether or not people, such as accountants, act ethically is influenced by a number of factors that interact. These would include:

- The moral code/conscience of the individual accountant
- Expectations of the profession (such as set out in such a code)
- Expectations of peers — this could include the culture of the company/context

- Risks of unethical behaviour being detected — would need to consider levels of enforcement of behaviour here
- Consequences of being found to have acted unethically (e.g. would it mean going to prison)
- Consequences of the unethical behaviour to the individual (i.e. the rewards/expected outcome — is it worth lots of $s) and to others (if seen as not hurting anyone specifically, often people are more willing to distort the truth)
- Consequences of not acting ethically (e.g. if being pressured by management to distort accounts would you lose your job/promotion if you do not act unethically)
- Personal circumstances

While a *Framework* can provide guidelines and can be used by individuals to defend ethical behaviour, in reality a number of factors combine. A key factor is the character of the individual; there will always be individuals who do the right thing regardless of consequences to themselves, and others who will readily 'do wrong' for their own benefits.

Re-enforcing or penalising in cases where there is debate about the whether a particular action is or is not unethical, it is likely that, as a broad set of principles, it is open to interpretation that this would make enforcement in these 'borderline' cases more difficult.

4. Would a set of specific rules about what constitutes ethical and unethical behaviours in specific circumstances be more or less useful than the principles in the code of conduct outlined? (J)

A broad set of principles can mean different interpretations (so less consistency) and can lead to people interpreting events as outside the restrictions placed by the principles.

The advantages of specific rules (rather than principles) are that it is clearer whether an action is or is not ethical. Therefore, less ambiguity, more consistency and it would be easier to enforce and penalise. However, requirements into narrowing rules means that as long as the rule meet actions outside of the specific rules are not 'unethical' as the rules specify ethical and unethical behaviours. Also, in practice you cannot specify rules for every possible scenario/situation. An analogy is the advantages and disadvantages of principles based accounting standards versus rules based as discussed in chapter 3.

While there may be ambiguities in a broad set of principles, it is often argued that principles require a higher level consideration of overall ethics (so place a higher burden of responsibility on the individual in making the judgement as to whether something is or is not ethical). To justify behaviour, if specific rules are set, the individual only needs to argue that they have followed the rules; not that their action is ethical in accordance with a set of higher order principles.

Case Study 2.2 ***What's new in water and carbon accounting***

1. **In the preface to the water accounting conceptual framework a wide range of users are identified including groups and associations with water related interests, water industry consultants, academics and interested citizens. This is much broader than the primary users that are the focus on the accounting conceptual framework. In the context of water reporting, is such a wide user groups appropriate and what possible problems could this result in? (J, K)**

The users identified in this water conceptual framework are outlined in para 19 of the preface:

> 19. The users of GPWAR fall into a broad range of categories. These include:
> - water users – environmental, agricultural, urban, industrial and commercial
> - investors in water dependent enterprises and related parties such as lenders, creditors, suppliers, insurers and water traders and water brokers
> - government representatives and their advisors, including water related economic, environmental and social policy makers
> - water industry regulators
> - water managers including environmental water managers and water service providers, who may be interested in not just the water entities they manage but water entities they depend on or compare to
> - groups and associations with water related interests
> - water industry consultants
> - academics

• interested citizens.

(http://www.bom.gov.au/water/about/consultation/document/WACF_August09.pdf)

There is no correct answer here but students may note the following:

- The group of users is extremely wide and as stated in the preface itself “The users information needs can vary enormously based on particular circumstances and the type of decisions or assessments being contemplated or undertaken’ (para 20). This is in sharp contrast with the *Conceptual Framework (*as revised) for accounting which narrows users to particular resource providers. Some may argue that such a wide user group is appropriate as water is one of our basic needs, and hence all society is directly or indirectly affected by water policy/availability/quality/cost. Others could argue that such a wide user group could make such reporting ‘less useful’.
- Problems with such a wide user group could possibly include; it could restricting information to that common amongst all groups or alternatively, trying to provide information to meet most of these groups could make reports complex/ and detail provided could obscure (or at least not highlight) more important reporting aspects/outcomes. Also given such a wide range of users group issue such as understandability of reports could be problematic, as such wide user groups would have varied knowledge/skills. or

2. Do you think the same qualitative characteristics would be equally important and appropriate to water accounting and reporting? (J)

Again there is no correct answer here but students could consider following:

- The qualitative characteristics in the accounting Conceptual Framework are aimed at decision usefulness; i.e. ensuring that the information provided is useful in decision making. Although the types of decisions made will or will not vary using accounting and water reports, these basic qualities (i.e. relevance, representational faithfulness, verifiability, comparability understandability) would be required. It could be argued that the qualitative characteristics are broad enough (and also recall need to balance these) to be able to be used and interpreted to particular circumstances.
- Of course this will not result in the same information being provided but should result in standards of the quality of information being met.
- Logically it could be expected that relevance, representational faithfulness would be the key qualitative characteristics on any framework which has decision usefulness as its objective. However, given issues such as the wide user group, whether the other qualitative characteristics would be equally important could be debated. For example, understandability

may have primacy over some of the other characteristics if needed given broader user groups. Or if reports being made about water allocation, then comparability may be paramount.

3. **What are the possible advantages and disadvantages of using the conceptual framework for financial reporting as a basis or starting point for conceptual frameworks for reporting in other contexts? (J, K)**

Again there is no correct answer here but students could consider following:

- As the accounting conceptual framework is established and in place for some time (so in some ways already working or tested) this could be of advantages as could: reduce possible mistakes made (learn from what others have already done); reduce time taken to develop a conceptual framework as already have much of structure etc; could enhance acceptance if viewed as based on existing and already accepted framework
- The disadvantages would be that this may result in a less than optimal conceptual framework for water. Whilst the accounting conceptual framework is in place there are criticisms of and problems with this as we have noted in this chapter. If it is believed that the nature of many water entities and their users, and the decisions they make are sufficient different that than accounting entities and their general purpose financial reports is could be argued that basing a water conceptual framework on this is problematic. Perhaps with decision such as allocating water resources etc qualitative (rather than quantitative) factors such as social justice, environmental impacts may be more important. Can the accounting conceptual framework, which focuses primary on economic and quantitative information, be adequately adapted to such contexts?

Case Study 2.3 ***Companies brace for powerful impact of lease accounting changes***

1. **The first extract above identifies a number of possible economic consequences if the proposed new lease standard is introduced. Outline the economic consequences identified and discuss whether you believe that the cost constraint in the *Conceptual Framework* would or should require consideration of these. (J, K, AS)**

The economic consequences identified in the first extract are the potential changes in the leasing market. This may be reduced as companies may opt to purchase property rather than lease (this could also impact on property markets/prices). Lessors could also be affected if lessees do not wish to undertake long term leases (this could arguably increase risk profiles for lessor).

The basic principle of the cost constraint in the conceptual framework is that the benefits of providing information should out weight the costs. The conceptual framework itself identifies the following costs:

- Costs by preparers of providing the information
- Costs by users of analysing information provided
- Cost to users of reduced returns if sufficient information for decisions is not provided (or costs to obtain this information elsewhere).

These seem to focus costs primarily on the costs of information and this appears reinforced in the conceptual framework which states:

> In applying the cost constraint, the Board assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. QC38

However para QC37 of the conceptual framework notes that if appropriate information is provided (i.e. relevant and representationally faithful information) this will assist users in making decisions and this in turn will result in efficient capital markets and a lower cost of capital. This suggests that economic consequences (and costs) could or should be taken into account. There is there is still debate as to whether economic consequences should be considered when deciding on accounting standards. It could be argued that the current lease accounting requirements (where operating leases are off balance sheet) have distorted the market.

2. The second extract discusses the costs to preparers.

(a) Discuss whether you believe the costs to preparers and valid and whether these should override the benefits?

(b) The extract proposes that a simpler method be applied to leases for less than 12 months. Discuss any disadvantages with this approach and whether this approach could this be justified using principles in the *Conceptual Framework*? (J, K)

(a) The costs to prepares outlined in the second extract is of complying with the proposals to recognise an asset and a liability , using discounting techniques – as opposed to a simpler method of simply expensing payments and making additional disclosures. Validity could be argued either way:

- Cleary the proposals are more complex than the expense and disclose method suggested so could be argued therefore increased costs
- However, accountants (or prepares) are required to use discounting methods for a range of accounting requirements (so expertise should already exist) and with computer programs already available (including those specific to accounting for leases) it could be argued that the actual additional costs in applying the requirements in the proposal would in fact by minimal.

(b) Again student could argue either way:

- Could argue that costs would appear to be minimal if provide better information for users to make more informed decisions. Also, if there is 'one' method for accounting for all leases this should increase comparability (as all companies using these assets, whether leased or owned, would need to include n the balance sheet).
- Could argue that simplified requirements for short term leases may be appropriate. How likely is it that such short term leases would significantly impact on decisions (i.e. are material). If not likely to influence decisions then more complex accounting treatment not required and so costs would outweigh benefits. However this could provide a 'loop hole'.

3. The proposed new leasing standard requires that contingent rental payments (for example, where lessee pays additional rent payments if revenue exceeds a certain amount) be included in lessees liabilities by lessee using the expected outcome approach that is described in the ED as "the present value of the probability-weighted average of the cash flows for reasonable number of outcomes" (para 14). The current leasing standard does not have such a requirement and contingent rentals are simply expensed as paid.

(a) Which of these approaches do you believe is more consistent with the definition and recognition criteria for liabilities in the *Conceptual Framework*?

(b) In undertaking this analysis, identify any problems or alternative interpretations that you had in applying the principles in the *Conceptual Framework.* (J, K, AS)

Students should apply the definition and recognition criteria for liabilities from the framework.

- Possible outflow of economic benefits
  - Yes — if revenue exceeds a certain amount then would be required to make additional rent payments

- A present obligation due to a past event
  - This could be debated.
  - One view is that the lease contract, which includes the requirement to pay additional lease rentals if and when certain conditions arise, is a present obligation due to the terms of the contract. This is the view taken by the Board.
  - As the Basis for Conclusions state:

> The liability to pay contingent rentals and the right to receive lease payments exist at the date of inception of the lease. Such contingent rentals meet the definition of a liability for the lessee and an asset for the lessor. It is only the amount to be paid that is uncertain. BC 123

This is also consistent with approaches towards employee benefits.

- An alternative view would be that a present obligation to pay these contingent rentals only arises when and if a future event occurs (such as revenue exceeding the amount specified). It should be noted that this view was rejected by the Board, who also noted that allowing this may also encourage creative structuring of leases.

Recognition criteria

- Probable that outflow will occur.
  - Presumably this would be based on facts available and likelihood that will be required to make payments (e.g. that revenue will exceed that specified) and if 50% or more then would be probable. Would assume that this was considered when entering into contract.

- Measure reliably
  - This again would depend on facts and would assume that this was considered when entering into contract. There would be various ways of estimating and an outcome approach, as proposed by the Board , would seem reasonable.

The conceptual framework would justify these contingent rentals as meeting the definition of a liability. Also, depending on the facts, these would also meet the recognition criteria of the conceptual framework. However the proposed standards discussed did not require the probability threshold (or 50%) to be met; rather that regardless of the probability these should be recognised (and the probability would be reflected in the measure as this is to be based on an expected outcome approach.